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In the Supreme Court of the United States

THE LONG ISLAND SAVINGS BANK, FSB and THE LONG ISLAND SAVINGS BANK OF CENTEREACH FSB,
Petitioners,

v.

UNITED STATES OF AMERICA,
Respondent.

On Petition for a Writ of Certiorari to The United States Court of Appeals for the Federal Circuit

PETITION FOR A WRIT OF CERTIORARI

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QUESTIONS PRESENTED

The Federal Circuit's decision in this breach-of-contract case vacated petitioners' $436 million judgment against the government because, during the contracting process, an officer represented on behalf of petitioner LISB that it was in compliance with all applicable laws. That same individual actually had a personal conflict of interest that he concealed from petitioners. According to the Federal Circuit, that conflict of interest placed petitioners in violation of a federal banking regulation and rendered the representation of compliance false. The Federal Circuit accordingly held that the contract at issue was void *ab initio* as a matter of federal common law, allowing the government to disregard its reciprocal obligations under the contract even though petitioners' performance was entirely satisfactory. Alternatively, the court held the government's breach of contract excused by petitioners' inaccurate representation because "any degree of fraud is material."

The questions presented are:

1. Whether, as a matter of federal common law, a government contract is void *ab initio* if its formation was induced by a misrepresentation.

2. Whether, as a matter of federal common law, a government contractor commits a breach of contract that is *per se* material — and that accordingly relieves the government of liability on the contract even after it has received and retained the benefits of the contractor's entirely satisfactory performance — if the contractor made either (a) a false statement or (b) a misstatement of fact, even if innocently made, that could have affected the government's decision to enter into the contract.

RULE 14.1(b) STATEMENT

Petitioners are The Long Island Savings Bank, FSB and The Long Island Savings Bank of Centereach FSB, who were plaintiffs and appellees below. The respondent is the United States of America, which was defendant and appellant in the courts below.

RULE 29.6 STATEMENT

Astoria Financial Corp. is the parent corporation of the successor entities of petitioners The Long Island Savings Bank, FSB and The Long Island Savings Bank of Centereach FSB, and is the only publicly held entity that owns more than 10% of the stock of either petitioner.

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PETITION FOR A WRIT OF CERTIORARI

OPINIONS BELOW

The Federal Circuit decisions, App., *infra*, 1a-37a, and 38a-68a, are reported at 503 F.3d 1234 and 476 F.3d 917. The post-trial opinion of the Court of Federal Claims, App., *infra*, 69a-169a, is reported at 67 Fed. Cl. 616. The opinion of the Court of Federal Claims denying the government's motion for summary judgment and granting petitioners' motion for partial summary judgment, App., *infra*, 170a-198a, is reported at 54 Fed. Cl. 607. The orders of the court of appeals on rehearing, App., *infra*, 199a-200a, and 201a-202a, are unreported.

JURISDICTION

After revising its opinion, the court of appeals entered its judgment on September 13, 2007, and denied rehearing on December 28, 2007. This Court has jurisdiction pursuant to 28 U.S.C. § 1254(1).

STATEMENT

The Federal Circuit's decision in this breach-of-contract case vacated a $436 million judgment that petitioners won against the United States and ordered that summary judgment instead be entered *in favor* of the government. The court held that petitioners are entitled to *no* relief for the massive injury inflicted upon them by the government's breach of contract because, although petitioners performed their end of the bargain fully and to the government's satisfaction, one of petitioners' officers made a misrepresentation that "tainted" the formation of the contract. This manifestly inequitable decision rests

on two fundamental, closely related interpretations of federal common law, each directly at odds with the contract principles that should define federal law in this area. See, *e.g.*, *United States* v. *Winstar Corp.*, 518 U.S. 839, 895 & n.39 (1996).

The Federal Circuit first declared that a government contract is void *ab initio* — disentitling the contractor to *any* recovery under the contract notwithstanding the extent of its performance and injury — if the contract's formation was induced by a fraudulent misrepresentation attributable to the contractor. But as this and many other courts have recognized, a contract induced by a misrepresentation is *not* void *ab initio* — that is, an unenforceable nullity — unless the misstatement prevented the recipient from understanding the contract's essential terms. In all other circumstances, contracts induced by misrepresentation are treated as voidable — *i.e.*, subject to an award of contract damages but otherwise fully enforceable unless the affected party promptly exercises its option to disaffirm (or avoid) the contract when it learns of the misrepresentation.

The difference is fundamental: when a contract is voidable rather than void, courts must strive to return the parties to their respective pre-contract positions. The Federal Circuit's contrary conclusion that a government contract is void *ab initio* whenever the agreement was obtained through misrepresentation disregards this rule, is grossly unfair (particularly where the contractor has discovered and voluntarily disclosed the impropriety), conflicts with the holdings of other courts of appeals, and departs from this Court's precedent.

The Federal Circuit alternatively held that petitioners' assertedly false compliance representation

constituted a *material* breach of its contract with the government and therefore allowed the government to avoid its reciprocal obligations, for two independent reasons: (i) the representation assertedly influenced the government's decision to enter into the contract; and (ii) "any degree of fraud is material as a matter of law." App., *infra*, 33a. But contract law authorities, including other courts of appeals, have consistently recognized that those considerations do not determine whether a contract breach was material. Instead, the materiality inquiry is properly concerned with the effect of the breach on the *performance* promised to the non-breaching party. These courts recognize that a breach is material, in the sense of justifying the cessation of performance by the non-breaching party, only if it actually and substantially deprives the non-breaching party of the expected benefit of its bargain. This rule differs significantly from the Federal Circuit's materiality test, which provides that *any* intentional misrepresentation is treated as a material breach, as are *all* misstatements of fact (even if entirely innocent) that affect the contract's formation, irrespective of whether that conduct had any impact at all on the performance bargained for by the non-breaching party.

These deviations from general contract principles have enormously significant practical consequences. The Federal Circuit's void *ab initio* doctrine nullifies any government contract "tainted" by a fraudulent misstatement attributable to one of the contracting parties. In contrast, the common law would treat these contracts as generally enforceable, although subject to possible disaffirmance, equitable unwinding, or damages claims. The Federal Circuit's materiality standard is equally consequential, allowing parties to a government contract to renounce their

performance obligations in circumstances where the common law would pronounce them still bound, although also entitled to seek any damages flowing from the other party's breach.

Both of these rules, as applied here by the Federal Circuit, would permit the government to disavow its obligations under contracts that the other party already has substantially performed, even where the government has suffered no injury whatsoever. Because this holding departs from law recognized by other courts, threatens to greatly disrupt the government contracting process, and leads to startlingly inequitable results, further review is warranted.

A. The Contract

This dispute arises out of the government's efforts to enlist healthy banks to help resolve the savings-and-loan crisis of the 1980s, and the government's subsequent decision to break a central promise it had made to induce the cooperation of those institutions. See generally *Winstar*, 518 U.S. at 844-58.

In 1982, petitioner Long Island Savings Bank ("LISB") was a "conservatively run, 'plain vanilla' bank" with branches in Queens, Nassau, and Suffolk counties of New York State. App., *infra*, 71a. Unlike many other thrifts of the time, whose financial troubles threatened to expose the federal government to billions of dollars in deposit insurance liability (see *Winstar*, 518 U.S. at 847), LISB was healthy and seeking opportunities to grow in its home market. App., *infra*, 71a-72a. In August 1982, LISB offered to acquire two sizeable thrifts that had been merged by the Federal Savings and Loan Insurance Corpora-

tion ("FSLIC"). *Ibid.* LISB's offer was expressly conditioned on receiving authorization to amortize, on a straight-line basis over a 40-year period, the supervisory goodwill arising from the merger.[1] FSLIC did not immediately respond to this offer (*id.* at 73a), instead launching a nationwide solicitation for potential acquirers. LISB submitted a series of bids, each of which reincorporated the above accounting treatment. This steadfast negotiating position reflected LISB's "overriding goal": "to protect itself from [the failing thrift's] tangible-capital deficit" (*id.* at 75a).

Upon determining that LISB's bid was the "most favorable" of the six it received, FSLIC sold LISB the stock of the failing institution for $100,000 cash consideration. App., *infra*, 76a-77a. As part of the acquisition, FSLIC and LISB concluded an "Assistance Agreement" in August 1983, pursuant to which LISB assumed responsibility for the failing thrift's obligations and agreed to maintain specified levels of net worth. *Id.* at 79a.

In this regard, the parties agreed to LISB's right to record substantial amounts of goodwill on its books and to employ favorable accounting treatment — including straight-line amortization — to that goodwill. App., *infra*, 79a, 108a-120a. The importance of this provision cannot be overstated. As the trial court later found, "[a]bsent the ability to include

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[1] The term "supervisory goodwill" was used to denote the portion of the purchase price of an acquired thrift that exceeded the fair value of its identifiable assets. *Winstar*, 518 U.S. at 848-849. Then-applicable accounting principles "expressly contemplated its application to at least some transactions involving savings and loans." *Id.* at 849.

this massive amount of goodwill [some $625.4 million] in the computation of [the new thrift's] regulatory capital, [the new thrift] would have had a negative net worth of approximately $550 million and, on a consolidated basis, would have overwhelmed [LISB's] retained earnings." *Id.* at 79a. If not for the favorable accounting treatment, the deal could not have been consummated; LISB and the new institution "would immediately have been insolvent under federal standards if goodwill had not counted toward regulatory net worth." *Winstar*, 518 U.S. at 850-851.

The contract had another relevant component: FSLIC's obligations under the Assistance Agreement were conditioned upon receipt of a certificate from LISB's Chairman stating that the "representations and warranties of LISB set forth in § 11(b) are true and substantially correct." Of particular importance here, the Assistance Agreement required LISB to warrant that, except as otherwise disclosed,

> LISB is not in violation of any applicable statutes, regulations or orders of, or any restrictions imposed by, the United States of America or any state, municipality or other political subdivision or any agency of the foregoing public units, regarding the conduct of its business and the ownership of its properties, including, without limitation, all applicable statutes, regulations, orders and restrictions relating to savings and loan associations, equal employment opportunities, employment retirement income security, and environmental standards and controls where such violation would materially and adversely affect LISB's business, operations or condition, financial or otherwise.

App., *infra*, 4a-5a (quoting Assistance Agreement § 11(b)(5)). In addition, the Assistance Agreement required LISB to affirm that it had provided all material information to FSLIC and had not omitted any material fact. *Id.* at 5a (citing Assistance Agreement § 11(b)(9)).

The Assistance Agreement and the certificate were signed by LISB's then-Chairman and CEO, James A. Conway, Jr. Upon completion of this and other pre-conditions, LISB's acquisition of the failed institution, renamed the Long Island Savings Bank of Centerreach, was complete. The rescue quickly proved successful. LISB and Centereach (collectively "the Banks"), operated essentially in tandem by a management team later described by one government regulator as "sterling," App., *infra*, 123a, employed a "very conservative [lending] philosophy" that, over time, reduced the tangible-capital deficit that had previously plagued Centereach. *Id.* at 80a All told, "[b]etween 1983 and 1989, [the Banks] on a consolidated basis increased their total assets from $4.1 billion to $5.3 billion and total deposits from $3.2 billion to $4.4 billion." *Id.* at 81a.

B. The Government's Breach And Its Consequences For The Banks

On August 9, 1989, Congress enacted the Financial Institutions Reform, Recovery, and Enforcement Act ("FIRREA"), Pub. L. No. 101-73, 103 Stat. 183, a law that retroactively eliminated the ability of acquiring thrifts to count supervisory goodwill toward capital requirements. *Winstar*, 518 U.S. at 857. As this Court has held, FIRREA breached the government's contracts with financial institutions that had acquired failing thrifts. *Ibid.* In particular, "[t]he impact of FIRREA's new capital requirements upon

institutions that had acquired failed thrifts in exchange for supervisory goodwill was swift and severe." *Ibid.* For the Banks, the effect was catastrophic: FIRREA eliminated $458 million of the approximately $492 million of supervisory goodwill on Centereach's books, effectively abrogating the crucial, bargained-for contract provision that authorized the Banks to amortize this goodwill over a 40-year period. As a consequence, the Banks immediately fell out of compliance with federal regulatory standards. App., *infra*, 82a-83a.

The government thus forced the Banks to embark on a multi-year restructuring effort to achieve compliance with the accounting standards newly mandated by Congress. This effort, carried out under the oversight of the Office of Thrift Supervision ("OTS"), a regulatory agency likewise created by FIRREA, was extensive. The Banks sold off a series of substantial assets — including approximately $1 billion in deposits, several branches, real estate holdings, and a package of underperforming loans — wrote off goodwill, and underwent a conversion to a consolidated stock corporation via a 1994 initial public offering. App., *infra*, 82a-107a. The effort also was tremendously expensive: the Banks spent over $252 million to carry out these measures. *Id.* at 167a-168a. But it ultimately succeeded; by 1994 the Banks had returned to full regulatory compliance under conditions that would permit them to compete in their home metropolitan New York City market. *Id.* at 104a, 132a.

C. Conway's Personal Enrichment Scheme

From December 1982 to June 1992, Conway served as LISB's Chairman and CEO. During this period, Conway also served as a partner and stock-

holder of a New York law firm that did considerable business with the Banks. App., *infra*, 172a. In fact, from 1982 to 1991, Conway's firm served as the primary mortgage loan closing counsel for LISB, collecting over $20 million in loan closing fees in the process. *Id.* at 173a. These facts were known to petitioners and were not inconsistent with the representations it had made to the government.

What the Banks did not know — because Conway actively concealed it from both the Banks and the government — was that Conway retained *majority* ownership of the firm and was receiving substantial remuneration derived from these loan closing fees, which comprised a considerable portion of the firm's total revenues. App., *infra*, 173a-174a. Conway had falsely denied that he was receiving income derived from the firm's work for the Banks, instead averring that, though he retained "an interest in a law firm that presently renders services to [LISB]," his compensation was derived solely "from *outside* income of said firm." *Id.* at 174a (emphasis added).

LISB did not become aware of Conway's scheme until 1992, when it was uncovered and (over Conway's objections) revealed by LISB's outside counsel. LISB promptly informed OTS and filed a criminal referral with OTS and other enforcement agencies. After a full investigation, OTS made no findings adverse to the Banks, brought no charges against the Banks, and concluded that the matter had not caused the Banks any out-of-pocket loss. It is undisputed that Conway's conflict neither affected the Banks' performance nor led OTS to conclude that the Banks had violated any applicable regulation or had been managed in anything other than a safe and sound manner. In fact, federal regulators consis-

tently praised the Banks' management. Of the parties to this case, the only ones to suffer even indirect injury from Conway's conduct were *the Banks*, which spent over $1 million in legal fees in connection with the OTS investigation into Conway's conflict. App., *infra*, 174a.

In contrast to the minimal harm to the Banks and the absence of harm to the government, the professional and personal consequences of the conflict for Conway were severe. The OTS proceedings concluded in a cease-and-desist order that barred him from the banking industry and required him to pay the Banks $1.3 million in restitution for their investigation expenses. App., *infra*, 175a. He also was indicted on federal criminal charges, pleading guilty to a misdemeanor offense. *Ibid.* He ultimately was disbarred. See *In re Conway*, 712 N.Y.S.2d 610, 611 (N.Y. App. Div. 2000) (per curiam).

D. Proceedings Below

1. The Court of Federal Claims

The Banks filed the instant action in the Court of Federal Claims ("CFC") in 1992, seeking contract damages for the government's breach or, in the alternative, rescission and *quantum meruit* recovery for benefits conferred on the government. Compl. 31 (prayer for relief ¶2).[2] Conway's conduct did not become a focal point of the government's defense until

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[2] The Banks originally filed suit in the Eastern District of New York on August 15, 1989, seeking, among other things, to rescind the contract and return Centerreach to the government — a remedy that the government repeatedly declined. That suit was voluntarily dismissed prior to the commencement of this action.

2001, some twelve years after petitioners first filed suit. Pointing to Conway's conflict of interest, the government asserted that the Banks' breach-of-contract claims were barred by 28 U.S.C. § 2514, which provides that "[a] claim against the United States" is forfeited by any person who practices a "fraud against the United States in the proof, statement, establishment, or allowance thereof." Additionally, the government argued that Conway's conduct rendered LISB's contract with the government void *ab initio* or, in the alternative, constituted a prior material breach of the contract that excused the government both of its obligation to perform and of all liability for its subsequent breach. These defenses were premised on a single theory: that Conway's illegal conduct placed LISB in violation of at least one federal, state or local law in 1983, when Conway represented LISB's compliance with all applicable laws, and that this "fraud" bars the Banks from obtaining *any* redress for the massive loss caused by the government's breach of contract.

The CFC rejected each of these defenses, finding that (i) Conway had successfully concealed his scheme from LISB, (ii) Conway's knowledge could not properly be imputed to LISB, and (iii) "the contract itself is not tainted by Conway's conflict-of-interest." App. *infra*, 198a. The CFC subsequently held a 24-day trial to resolve outstanding questions of fact relating to liability and damages, resolving almost all of these issues in the Banks' favor and entering judgment against the United States for $435,755,000. *Id.* at 15a.

2. The Federal Circuit

a. On appeal, the government renewed its contention that 28 U.S.C. § 2514 required forfeiture of

the Banks' damages claims, arguing that Conway's 1983 representation that LISB was in compliance with all applicable laws amounted to a fraud "in the proof, statement, establishment or allowance" of the Banks' 1992 contract claim against the United States. The government also argued that Conway's conduct constituted a prior material breach of contract by LISB that absolved the government of all liability for its own breach. Notably, the government did not renew its trial argument that the LISB contract should be deemed void *ab initio*.

The Federal Circuit accepted the government's argument that the Banks' contract claims were forfeit under Section 2514. App., *infra*, 15a. The court reasoned that: (i) LISB's compliance representation was false because Conway's personal conduct made LISB non-compliant as a matter of law with 12 C.F.R. § 563.17, a regulation requiring banking institutions to operate in a "safe and sound" manner, or, at a minimum, that LISB had failed to reveal a fact necessary to make its representation of compliance not misleading; (ii) Conway intended to deceive the government by falsely representing LISB's compliance (although this fact-intensive question had never been tried); and (iii) Conway's intent and knowledge could be imputed to LISB. App., *infra*, 22a-23a. This decision vacated the entire $436 million award and instead granted summary judgment to the government.

The Banks sought rehearing, arguing that the panel had given textually unwarranted breadth to Secton 2514 and had improperly resolved numerous disputed issues of fact and agency law against the Banks. The *en banc* court granted the Banks' peti-

tion "for the limited purpose of returning the case to the merits panel." App., *infra*, 202a.

b. Acting without additional briefing or argument, the panel then issued a revised opinion (App., *infra*, 1a-37a), again denying the Banks any recovery for the government's breach because, in light of Conway's conduct, LISB could not have been operating in a "safe and sound" manner, rendering LISB's representation false. *Id.* at 20a-23a. The panel also reiterated its view that Conway's purported knowledge of this falsity could be imputed to LISB. *Id.* at 23a. But the panel changed its theory of *why* these circumstances absolved the government of liability.

Abandoning its previous reliance on Section 2514, the panel instead concluded that two alternative federal common law rules (the first of which was not addressed in the parties' briefs) defeated the Banks' claims for redress. First, the panel held that a contract is "tainted by fraud" and therefore void *ab initio* whenever "the contractor (a) obtained the contract by (b) knowingly (c) making a false statement," App., *infra*, 20a-21a. The panel found that test satisfied here because LISB's compliance representation was a knowingly false statement that caused or, at a minimum, contributed to, the government's decision to enter into the Assistance Agreement.[3] *Id.* at 24a. Second, and alternatively, the revised opinion con-

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[3] The panel sidestepped the government's failure to raise this argument on appeal, opining that the federal common law issue whether the contract was void *ab initio* was "properly before [the] court," even if not "*explicitly* appealed," because it was "inextricably linked to, and is thus fairly included within," the statutory interpretation question presented by the government's Section 2514 defense. App., *infra*, 18a.

cluded that, "[e]ven if the contract were not void, the doctrine of prior material breach precludes the plaintiffs' breach of contract claim for damages" because Conway's misconduct rendered LISB's compliance representation false. *Id.* at 31a. According to the panel, this false representation was a "failure of performance" that was material for two reasons: because Conway's false statement was at least a contributing factor to the government's decision to enter into the contract,[4] and because, in the Federal Circuit's view, "*any* degree of fraud is material as a matter of law." *Id.* at 33a (emphasis added). For these reasons, the panel concluded, LISB's claim for contract damages was entirely barred. *Id.* at 36a.[5]

REASONS FOR GRANTING THE PETITION

The contract rule applied by the Federal Circuit in this case — and the result it produced here — is perverse. Even assuming that Conway's concealed conflict of interest placed LISB out of compliance with federal rules and therefore made LISB's compliance representation inaccurate, it is undisputed that this error did not injure the government *at all*: LISB performed its end of the contract fully and as promised. Yet the Federal Circuit nevertheless held that Conway's misconduct (which the Banks discov-

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[4] This highly debatable conclusion was reached even though there was no trial of the question.

[5] The panel stated briefly that "contract law provides for other theories of recovery" but gave the point no further consideration because, it said, the Banks sought "only contract damages." App., *infra*, 37a. In fact, the Banks' complaint also sought *quantum meruit* recovery in the amount of their expenses in operating the failed thrift and the reasonable value of benefits that they conferred on the United States. Compl. 31 (prayer for relief ¶ 2).

ered and voluntarily disclosed) automatically allowed the government, which had refused LISB's request for rescission, to disavow its end of the contract *after* LISB had fully performed, leaving LISB remediless for a breach by the government that caused it hundreds of millions of dollars in injury.

Not surprisingly, this holding is inconsistent with decisions of this Court and other courts of appeals. Under the general contract principles that are applied by other courts and should govern here, fraud in the inducement does *not* render a contract void *ab initio* and therefore wholly unenforceable, and a breach of contract is *not* material unless the contracting party has been denied the benefit of its bargain. The Federal Circuit's contrary holding here — which has nationwide effect, given that court's exclusive appellate jurisdiction over all contract claims seeking damages of more than $10,000 from the government — will allow the government to avoid its obligations whenever it can identify even harmless and immaterial irregularities in the contracting process; will lead (as here) to shockingly inequitable results; and, as a consequence, will greatly unsettle the government contracting process. Review by this Court, to correct the Federal Circuit's damaging and poorly considered rule, therefore is urgently needed.

I. THE FEDERAL CIRCUIT'S RULING THAT A GOVERNMENT CONTRACT INDUCED BY FRAUD IS VOID *AB INITIO* IS CONTRARY TO FIRMLY ESTABLISHED PRINCIPLES OF CONTRACT LAW AND CONFLICTS WITH DECISIONS OF THIS COURT AND OF OTHER CIRCUITS.

A. A Contract Induced By A Misrepresentation Of Material Fact Is Voidable Rather Than Void.

Whether the Banks' contract with the government is deemed void rather than voidable is a difference worth hundreds of millions of dollars: if it is void the Banks are left without a remedy for the government's breach, while if it is voidable the government could not disaffirm the contract while simultaneously retaining the benefits of the Banks' performance. And the test to distinguish between contracts deemed void *ab initio* and those deemed merely voidable is well settled. A misrepresentation made by one contracting party to another renders a contract void *ab initio* only if, "because of a misrepresentation as to the character or essential terms of a proposed contract, a party does not know or have reasonable opportunity to know of its character or essential terms." Restatement (Second) of Contracts § 163 cmt. a (1981). This type of misrepresentation is commonly described as a "fraud in the factum." See, *e.g.*, *Langley* v. *F.D.I.C.*, 484 U.S. 86, 93 (1987). In such a case, because the deceived party "believe[s] that he is not assenting to any contract or that he is assenting to a contract entirely different from the proposed contract," courts treat the underlying agreement as if it had never existed. Restatement (Second) of Contracts § 163 cmt. a. See also 1 Willis-

ton on Contracts § 1:20 (4th ed. 1990) ("If an agreement is void, it cannot be a contract, for the law will neither give a remedy for its breach nor recognize as a duty its performance.").[6]

The consequences of a misrepresentation that deceives the other party about the circumstances surrounding the formation of the contract, but not about the essential terms of the agreement, are entirely different. "If a party's manifestation of assent is induced by either a fraudulent or a material misrepresentation by the other party upon which the recipient is justified in relying, the contract is *voidable* * * *." Restatement (Second) of Contracts § 164(1) (1981) (emphasis added). See also 1 Corbin on Contracts § 1.6 (1993); 1 Williston on Contracts § 1.20.[7] Unlike a contract that is void *ab initio*, a voidable agreement is generally effective and enforceable (see 1 Williston on Contracts § 1:20), although courts permit the deceived party to avoid or "disaffirm" the

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[6] A classic example posits: "A and B reach an understanding that they will execute a written contract containing terms on which they have agreed. It is properly prepared and is read by B, but A substitutes a writing containing essential terms that are different from those agreed upon and thereby induces B to sign it in the belief that it is the one he has read. B's apparent manifestation of assent is not effective." Restatement (Second) of Contracts § 163 cmt. b, illus. 2.

[7] In the classic example, "A, seeking to induce B to make a contract to sell him goods on credit, tells B that he is C, a well-known millionaire. B is induced by the statement to make the proposed contract with A. B's apparent manifestation of assent is effective. However, the contract is voidable by B * * *." Restatement (Second) of Contracts § 163 cmt. a, illus. 1.

contract if the deceived party affirmatively acts to do so promptly upon learning of the misrepresentation. See, *e.g.*, *Landenburg Thalmann & Co.* v. *Imaging Diagnostic Sys., Inc.*, 176 F. Supp. 2d 199, 204 (S.D.N.Y. 2001) (citing 1 Corbin on Contracts § 1.6).

Avoidance of a voidable contract is a rescissionary remedy, governed by principles of equity, that is intended to return the parties to the position they would have occupied had the contract not been consummated. See Restatement (Second) of Contracts § 164 cmt. a. ("Even if the contract is voidable, exercise of the power of avoidance is subject to the limitations stated * * * on remedies."). Accordingly, where a party "claims that it has been fraudulently induced into entering into a contract and it has successfully proved its claim it cannot void the contract and at the same time continue to keep the benefits under the contract." *Goney* v. *E.I. Du Pont de Nemours & Co.*, 144 F. Supp. 2d 1286, 1290 (M.D. Fla. 2001).

These standards are routinely applied by both federal and state courts. See, *e.g.*, *Sphere Drake Ins. Ltd.* v. *Clarendon Nat'l Ins. Co.*, 263 F.3d 26, 31 (2d Cir. 2001) ("[A]n allegation of fraud in the inducement is a defense that renders contracts voidable, but not void."); *Shaw's Supermarkets, Inc.* v. *Delgiacco*, 575 N.E.2d 1115, 1117 (Mass. 1991) ("A contract induced by fraudulent misrepresentations is voidable, not void."). And under these standards, it is plain that LISB's contract with the government should, at worst, have been deemed voidable. Even if made with knowledge of its falsity, the compliance representation did not deceive the government as to the nature and essential terms of the bargain. Accordingly, Conway's compliance representation was not a "fraud in the factum" and, under well nigh uni-

versal principles of contract law, did not render LISB's contract with the government void *ab initio*.

The Federal Circuit did not attempt to reconcile its holding with generally applicable principles of contract law, and did not rely for its rule on the Restatement or the decisions of any other court. Instead, it pointed to its *own* idiosyncratic view of contract law: "*We* have stated that * * * a Government contract tainted by fraud or wrongdoing is void *ab initio*." App., *infra*, 20a (emphasis added; internal quotation marks omitted). As demonstrated, this conclusion is clearly at odds with general contract principles, which reject the view that contracts "tainted" by fraudulent inducement are void *ab initio*. As such, it is equally at odds with this Court's longstanding admonition that, "where Congress has not adopted a different standard, [courts] apply to the construction of government contracts the principles of general contract law." *Priebe & Sons, Inc.* v. *United States*, 332 U.S. 407, 411 (1947). See *Winstar*, 518 U.S. at 895.

B. The Rule That A Government Contract Induced By Fraud Is Void *Ab Initio* Conflicts With Decisions Of Other Courts Of Appeals And Departs From This Court's Precedents.

1. There Is a Multi-Circuit Conflict.

As the Federal Circuit itself acknowledged, the decision below exacerbates a conflict between the Federal and D.C. Circuits over whether a government contract "tainted by fraud" should be deemed void *ab initio* under federal common law. See App., *infra*, 20a & n.2 (noting disagreement expressed in *United States ex rel. Siewick* v. *Jamieson Sci. &*

Eng'g, Inc., 214 F.3d 1372, 1377 (D.C. Cir. 2000)). Both here and in prior cases, the Federal Circuit has answered that question in the affirmative. The D.C. Circuit, as demonstrated by its opinion in *Jamieson*, a False Claims Act case, strongly disagrees. The Fifth Circuit also rejects the view that a voidness doctrine should be incorporated into the federal common law of government contracts. See *Hayes Int'l Corp.* v. *McLucas*, 509 F.2d 247, 263 n.26 (5th Cir. 1975).

In *Jamieson*, a *qui tam* relator advanced substantially the same argument now promoted by the government and adopted by the Federal Circuit. The relator contended that employees of the defendant government contractor had committed violations of 18 U.S.C. § 207, a statute that bars "revolving door" abuses by former government employees. These violations of the statutory conflict of interest rule, the relator argued, were attributable to the contractor, and thus rendered the relevant government contract void *ab initio*. 214 F.3d at 1374, 1376.[8]

The D.C. Circuit squarely rejected this argument, noting that the void *ab initio* label and its consequences are "generally reserved for a handful of contracts that are seen as being in fundamental violation of public policy, such as agreements to do acts that both parties know will constitute a felony, or wagering agreements made in jurisdictions where gambling is illegal." *Jamieson*, 214 F.3d at 1377 (ci-

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[8] In the relator's view, this voidness made the contractor's claims for payments actionable under the False Claims Act because the contractor should have known that it was not entitled to the payments it received for its performance. *Jamieson*, 214 F.3d at 1374, 1376.

tation omitted). The D.C. Circuit declined to expand this category to include contracts "tainted" by fraud, recognizing that doing so would "vastly expand the normally minute group of contracts treated as void." *Id.* at 1377. Moreover, such a rule would deprive *the government* of the "option to treat [such a] contract as fully in effect." *Ibid.* (emphasis omitted). As the D.C. Circuit explained:

> Reasons why the government would wish to preserve that election abound: the officials authorized to decide might regard the violation as minor; they might think that the criminal penalties provide ample punishment of the present violation and deterrence of future ones; they might be concerned that disaffirmance would unduly impede future transactions with the contracting firm (possibly in possession of skills or other resources of exceptional value to the government) or with other potential contractors.

Ibid.

The D.C. Circuit also explained why, policy aside, the Federal Circuit was wrong in its prior statements that "government contracts 'tainted by fraud or wrongdoing' are 'void *ab initio*.'" *Jamieson*, 214 F.3d at 1377 (citing *J.E.T.S., Inc.* v. *United States*, 838 F.2d 1196, 1200 (Fed. Cir. 1988), and *Godley* v. *United States*, 5 F.3d 1473, 1476 (Fed. Cir. 1993)). These decisions purport to follow this Court's opinion in *United States* v. *Mississippi Valley Generating Co.*, 364 U.S. 520 (1961), a decision that addressed the contract consequences of a conflict of interest created by the criminal conduct of a contractor's employee. But as the D.C. Circuit explained, the *Mississippi Valley* Court did not hold that such a conflict of in-

terest renders the affected contract void *ab initio*. Rather, consistent with general principles of contract law, this Court described the contract as *voidable*, stating that the government had the right to "*disaffirm* a contract which is infected by an illegal conflict of interest." *Jamieson*, 214 F.3d at 1377 (emphasis added) (quoting *Miss. Valley Gen. Co.* at 566). See also Restatement (Second) of Contracts § 7 cmt. b (explaining that "[a]voidance is often referred to as disaffirmance"). The disagreement between the District of Columbia and Federal Circuits on this issue could hardly be more clearly drawn.

Like the D.C. Circuit, the Fifth Circuit has rejected the argument that federal common law should treat government contracts "tainted by fraud" as *void ab initio* — and has likewise rejected the Federal Circuit's view that this Court's decision in *Mississippi Valley* supports the contrary conclusion. In *Hayes International*, an unsuccessful bidder sought to set aside a federal procurement contract, claiming that the winning bidder had violated conflict of interest rules set forth in Department of Defense regulations. 509 F.2d at 248. Citing this Court's decision in *Mississippi Valley*, the plaintiff argued in pertinent part that the alleged conflict of interest should be deemed to have voided the contract. *Id.* at 263 n.26. But the Fifth Circuit disagreed that *Mississippi Valley* justified the "dramatic use of federal equity power" proposed by the plaintiff, concluding, in essence, that this Court's holding in that case represented nothing more than its interpretation of the particular federal statute there at issue. *Ibid.* Accordingly, it refused to develop "a novel 'federal common-law of Government procurement,' premised upon what a court can be persuaded is desirable pro-

curement policy." *Ibid.* This holding, too, cannot be reconciled with the Federal Circuit's approach.

2. The Federal Circuit's Voidness Holding Is Incompatible With Decisions of This Court.

For exactly the reasons identified by the D.C. and Fifth Circuits, this Court's decision in *Mississippi Valley*, rendered in any event "in an era when Supreme Court readiness to infer remedies from criminal statutes was at a high point," *Jamieson*, 214 F.3d at 1377, provides no support for the Federal Circuit's extraordinary holding that Conway's conduct, so tenuously connected to the subject matter of the contract, rendered the Banks' contract with the government void *ab initio*. Moreover, other decisions of this Court, both before and after *Mississippi Valley*, have endorsed the traditional distinction between void and voidable contracts, demonstrating that this rule is fully compatible with federal interests in the enforcement of contract rights.

At least since 1875, this Court has endorsed the rule that non-government contracts affected by an executive's private conflict of interest are not "absolutely void, but * * * are *voidable* at the election of the party whose interest has been so represented by the party claiming under it." *Twin Lick Oil Co.* v. *Marbury*, 91 U.S. 587, 589 (1875) (emphasis added). Accord, *Thomas* v. *Brownville, Ft. Ky. & Pac. R. Co.*, 109 U.S. 522, 524 (1883). More recently, the Court has concluded that this same rule should apply to contracts governed by federal law, holding in *Still* v. *Norfolk & Western Railway*, 368 U.S. 35, 38-39 (1961), that fraudulent inducement rendered a private employment contract voidable, but not void, for purposes of the Federal Employees' Liability Act.

Similarly, the Court applied the traditional rule distinguishing void from voidable contracts in construing 12 U.S.C. § 1823, a statute that governs the validity of contract provisions when the FDIC purchases or otherwise assumes the rights of a party to a private contract. See *Langley*, 484 U.S. at 94 (citing, *inter alia*, Restatement (Second) of Contracts § 163). There, the Court rejected a litigant's argument that allegedly fraudulent misrepresentations about the size or mineral properties of the parcel at issue could constitute a "fraud in the factum" rendering the underlying contract void *ab initio*, reiterating that these statements could "constitute only fraud in the inducement, which renders the note voidable but not void." *Ibid.*

These decisions demonstrate that this Court has consistently adopted and applied the traditional distinction between void and voidable contracts in all manner of cases, including those where important federal interests have been affected by the validity of the contract. Especially given the broad rule that general principles of contract law govern federal contracts, the Federal Circuit's conclusion that federal interests require use of an expansive and non-traditional definition of the circumstances in which a fraud renders a contract void *ab initio* stands in striking tension with this Court's precedents.

II. THE FEDERAL CIRCUIT'S MATERIALITY RULING IS CONTRARY TO FIRMLY ESTABLISHED CONTRACT LAW PRINCIPLES AND CONFLICTS WITH DECISIONS OF OTHER CIRCUITS.

The Federal Circuit also went badly astray in holding that the Banks' breach of contract was "material" (App., *infra*, 23a) in a manner that allowed

the government to disregard its contractual obligations rather than being remitted to its damages remedies. In reaching its conclusion, the Federal Circuit identified two circumstances that, it believed, constitute a *per se* material, and therefore voiding, breach of contract. First, it opined that "any degree of fraud is material as a matter of law," and therefore that every fraudulent misstatement uttered during the formation of a contract absolves the recipient of liability for any subsequent breach. *Id.* at 33a. Second, it held that the same result follows if a contracting party made any misstatement at all that caused the other party to enter into the contract, even if the misstatement was not "'wil[l]ful or even negligent.'" *Id.* at 33a n.4. But neither of these tests is derived from general principles of contract law, and neither is compatible with the materiality standards employed by common law courts, espoused by leading commentators, or applied to government contracts by other federal courts of appeals. Here, too, this Court's review is clearly warranted.

A. The Materiality Of A Contract Breach Is Measured By The Degree To Which It Deprives The Non-Breaching Party Of The Expected Benefit Of Its Bargain.

All of the leading contract authorities agree that a primary concern of the materiality inquiry is whether the alleged breach substantially deprived the non-breaching party of the benefit for which it bargained and upon which its promise to perform was therefore premised. Only that kind of grave breach is sufficient to relieve the non-breaching party of the duty to perform as the contract requires. In establishing *per se* tests of materiality that completely disregard the effect of the breach on the per-

formance promised by the breaching party, the Federal Circuit has opened an unwarranted gulf between general contract principles and federal common law.

Restatement (Second) of Contracts § 241(a)-(e) sets forth the generally accepted test for contract materiality. It describes as significant in making this determination "the extent to which the injured party will be deprived of the benefit which he reasonably expected" or "can be adequately compensated for the part of that benefit of which he will be deprived"; "the extent to which the party failing to perform" will "suffer forfeiture" and "the likelihood that the party failing to perform * * * will cure his failure"; and "the extent to which the behavior of the nonperforming party comports with standards of good faith and fair dealing." Individually and in combination, these factors focus on the relationship between the *performance* promised by the parties and the *performance* actually delivered. And appropriately so. For, as the Restatement further explains, the entire purpose of the material breach doctrine, including the rule that the occurrence of a material breach excuses the non-breaching party of its obligation to perform, is to "secure the parties' expectation of an exchange of performances." *Id.* at cmt. b.[9] Thus, a breach that has no impact on the breach-

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[9] See also 10-53 Corbin on Contracts § 946 ("A total breach of contract is a non-performance of duty that is so material and important as to justify the injured party in regarding the whole transaction as at an end."); 23 Williston on Contracts § 63:3 (4th ed. 2002) ("[F]or a breach of contract to be material, it must * * * be one which touches the fundamental purpose of the contract and defeats the object of the parties in entering into the contract.") (internal quotation marks omitted); Farnsworth on

ing party's performance is properly regarded as *immaterial*. See *Dick ex rel. Amended Hilbert Residence Main. Trust* v. *Conseco, Inc.*, 458 F.3d 573, 579 (7th Cir. 2006) ("Because Conseco would have suffered no actionable damages should Hilbert fail to perform, it would not have been entitled to sue him for material breach.").

Under this standard, the Banks' alleged breach could not possibly be thought material, nor did the Federal Circuit so suggest. After all, Conway's conduct (a) caused no harm to the government; (b) had no impact on the Banks' performance; (c) would inflict a massive forfeiture on the Banks if deemed material; and (d) was voluntarily disclosed to the government by the Banks in a clear demonstration of good faith. But the Federal Circuit instead applied *per se* rules that entirely disregard the impact of an alleged breach on performance.

B. The Federal Circuit's Materiality Ruling Conflicts With Decisions Of Four Other Circuits.

The First, Fifth, Seventh and Eighth Circuits each have concluded that the performance-focused materiality test set forth in the Restatement (Second) of Contracts § 241 should determine whether the breach of a government contract is sufficiently serious to excuse performance by the non-breaching party. See *Harris* v. *Brownlee*, 477 F.3d 1043, 1047 (8th Cir. 2007) ("Whether a breach of contract is material is measured by examining the 'extent to which the injured party will obtain the substantial benefit

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Contracts § 8.16 (3d ed. 1999) ("Most significant is the extent to which the breach will deprive the injured party of the benefit that it justifiably expected * * *.").

* * * reasonably anticipated.'"); *United States* v. *Baus*, 834 F.2d 1114, 1125 (1st Cir. 1987) ("In determining materiality in federal contract law, courts look to all the circumstances surrounding the contract and the breach and are also guided by general principles of contract law and the Restatement (Second) of Contracts * * *."); *E. Ill. Trust & Sav. Bank* v. *Sanders*, 826 F.2d 615, 616 (7th Cir. 1987); *Ferrell* v. *Sec'y of Def.*, 662 F.2d 1179, 1181 (5th Cir. 1981) (in determining materiality of a breach of contract "the general inquiry is whether the injured party has received substantially what he bargained for in spite of the breach").

In contrast, the Federal Circuit here expressly *rejected* the kind of effects-based materiality test espoused by the Restatement and other courts, instead applying an approach that is settled in (and only in) the Federal Circuit. The Federal Circuit has concluded that "any degree of fraud is material as a matter of law," and has found support for this view in the case law governing the False Statements Act, 18 U.S.C. § 1001 — thus incorporating a federal *criminal* law test of materiality into the federal common law of contracts. *Christopher Village, L.P.* v. *United States*, 360 F.3d 1319, 1336 (Fed. Cir. 2004) ("[T]he test of the materiality of a statement is whether a statement has a natural tendency to influence, or was capable of influencing, the decision of the tribunal in making a determination required to be made.") (internal quotation marks omitted).

But the materiality inquiry serves distinctly different purposes in these two bodies of law. The materiality standard applied under the False Statements Act and elsewhere in the criminal law distinguishes between statements that are, and are not,

significant enough to merit punishment. See generally *United States* v. *DiFonzo*, 603 F.2d 1260, 1266 (7th Cir. 1979). In contrast, irrespective of materiality, "[e]very breach gives rise to a claim for damages" (Restatement (Second) of Contracts § 236 cmt. a) if injury has been suffered. As such, contract materiality does not differentiate between actionable and non-actionable breaches. Instead, it addresses the very different remedial question, entirely foreign to the criminal law, whether the non-breaching party is entitled to halt his promised performance. Adopting the criminal law's definition of materiality to resolve this quintessential contracts question is directly contrary to this Court's instruction that general principles of contract law must govern federal law in this area.[10] *Winstar*, 518 U.S. at 895 & n.39. Accordingly, review of the Federal Circuit's materiality ruling, too, is plainly warranted.

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[10] The Federal Circuit also failed to recognize that, even when a prior material breach occurs, it does not necessarily "preclude" the breaching party's claim for contract damages. Rather, even when the occurrence of a material breach discharges the non-breaching party's obligation to perform, "the party in breach is entitled to restitution for any benefit that he has conferred by way of part performance or reliance in excess of the loss that he has caused by his own breach." Restatement (Second) of Contracts § 374(1). Accord, *e.g.*, *Fid.& Deposit Co.* v. *Rotec Indus. Inc.*, 392 F.3d 944, 946 (7th Cir. 2004); *Kutzin* v. *Pirnie*, 591 A.2d 932, 937 (N.J. 1991). Here, it is undisputed that Conway's conduct caused the government no loss whatsoever. Accordingly, even if their breach were somehow material, the Banks would still be entitled to restitutionary recovery in the full amount of the benefit they conferred on the government.

III. THE FEDERAL CIRCUIT'S ABERRANT CONTRACT RULES WILL HAVE SIGNIFICANT AND PERNICIOUS CONSEQUENCES FOR THE GOVERNMENT CONTRACTING PROCESS.

The need for review is especially acute because, apart from creating two intercircuit conflicts, the Federal Circuit's departure from settled principles of contract law will have significant and far-reaching practical consequences. The decision below announces that, if a government contractor or its agent makes any misrepresentation of fact during the formation of the contract, no matter how far removed from the contract's central purpose, the contractor stands to forfeit its entire performance, no matter how full, honest, and satisfactory. Wholly apart from its plain inconsistency with general contract principles and decisions of this and other courts, this error has great real-world significance.

First, the Federal Circuit's approach applies a sweeping and inequitable forfeiture rule to *every* substantial contract claim for damages against the United States, *every one* of which must be filed in a forum under the Federal Circuit's appellate jurisdiction. See 28 U.S.C. §§ 1346(a)(2), 1491(a)(1) (CFC given exclusive jurisdiction over contract claims against the United States exceeding $10,000); 28 U.S.C. § 1295(a)(10) & (b) (Federal Circuit given exclusive jurisdiction over appeals from Boards of Contract Appeals). Under the Federal Circuit's rule, the United States may retain the benefits of a contractor's performance after learning of a misrepresentation, even as it disavows its own obligations under the contract. This is a patently inequitable result. Consider, for example, a manufacturer that contracts

with the government to build a $436 million warplane, which it delivers, meeting the government's specifications in every respect. Before collecting payment, however, the contractor discovers and reports that one of its officers had a previously unknown conflict regarding some other transaction, the existence of which was inconsistent with the contractor's representation that it was in compliance with *all* federal, state and local laws and rules. Under the holding below, that "fraud" would allow the government to retain the warplane yet breach its obligation to make payment, notwithstanding the contractor's good-faith performance.

This sort of outcome, which one commentator has labeled a "stunningly harsh result" that "fails to articulate any policy rationale for extending prior precedent," Jerry Stouck, *Feature Comment: The Federal Circuit Reaffirms Its Hostility to "Fraud," A Term It Applies Broadly, With A New And Completely Revised Opinion In* Long Island Savings Bank v. U.S., 49 THE GOVERNMENT CONTRACTOR ¶ 401, at 1, 6 (Oct. 24, 2007), will undermine the process of government contracting, with baleful consequences for both private contractors and the United States. "Virtually every major government contract requirement contains a separate certification provision," 3-18 Federal Contract Management ¶ 18.11[1], many of which are similar in breadth to the representation offered by LISB. See, *e.g.*, *United States ex rel. Hopper* v. *Anton*, 91 F.3d 1261, 1267 (9th Cir. 1996) (school district certified that it would "meet all applicable requirements of state and federal laws and regulations"). Yet even a business that makes every effort to ensure that it is in compliance with every law to which it is subject will sometimes learn after the fact that its practices do not comport with

some legal requirement. Moreover, almost by definition, no enterprise can ever achieve absolute certainty that a *concealed* act of one of its officers or employees has not placed it in violation of some federal, state, or local law.

Given this reality, the Federal Circuit's forfeiture rule will be understood to place contractors substantially at the government's mercy.[11] As a consequence, and given the number and scope of technical requirements included in virtually all government contracts, this new forfeiture risk may well be too great for many would-be government contractors to bear. At a minimum, the risk will decrease the competition for and increase the cost of government contracts. Such an outcome is inevitable; the next time (to offer one of many possible examples) the government seeks the assistance of private institutions in addressing a financial crisis, potential bidders will think long and hard about LISB's experience in this case.

Second, such an outcome is not necessary to protect the interests of the United States, which may address fraud through many other common law and

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[11] This is not a fanciful concern. As Judge Jones noted in similar circumstances, "were a court to hold that any kind of government certification required in connection with federal government payment and reimbursement vouchers is material as a matter of law, the government could erase the crucial distinction between 'punitive' [False Claims Act] liability and ordinary breaches of contract by the simple expedient of requiring broad, boilerplate certifications." *United States* v. *Southland Mgmt. Corp.*, 326 F.3d 669, 680 (5th Cir. 2003) (Jones, J., specially concurring) (footnote omitted).

statutory remedies, both civil and criminal. Nor does the Federal Circuit's rule advance any intelligible anti-fraud policy; to the contrary, the holding below will, if anything, discourage voluntary disclosure of conflicts and other misconduct, even as the government *encourages* voluntary disclosure of violations.[12] Contractors should not be subjected to this sort of Catch-22. Moreover, as the D.C. Circuit noted, a rule *requiring* that contracts be declared void often will not be in the government's interest. *Jamieson*, 214 F.3d at 1377.

Finally, the need for review is not diminished by the Federal Circuit's opaque suggestion, evidently referring to the possibility of *quantum meruit* relief, that "contract law provides for other theories of recovery." App., *infra*, 37a. In fact, the CFC lacks jurisdiction to grant implied-in-law remedies like quantum meruit that ordinarily are available when recovery on a contract is not. See, *e.g.*, *Hercules, Inc.* v. *United States*, 516 U.S. 417, 424 (1996) (the CFC's jurisdiction does not extend to implied-in-law contracts, which are a "fiction of law where a promise is imputed to perform a legal duty"; rather, it is limited

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[12] Government contractors with contracts in excess of $5 million and a performance period of at least 120 days, except for commercial item contracts and contracts performed entirely outside the United States, are required to have in place a business code of ethics and an internal control system. See Federal Acquisition Regulation 3.1003; 3.1004(a) and 52.203-13. The internal control system must facilitate timely discovery of improper conduct in connection with government contracts and ensure corrective measures are promptly instituted and carried out. Many contractors also have voluntary disclosure programs, which are intended to promote early detection and correction of improper conduct by contractor relating to a government contract.

to the enforcement of express and implied-in-fact contracts, the latter being "founded upon a meeting of minds, which, although not embodied in an express contract, is inferred, as a fact, from conduct of the parties showing, in the light of the surrounding circumstances, their tacit understanding") (internal quotation marks omitted). Accordingly, the Federal Circuit's hint that future contractors whose contracts are voided by its Draconian forfeiture rules may obtain at least some alternative relief is illusory; the only court empowered to entertain a contract claim for more than $10,000 against the government lacks authority to offer the contractor relief in any other form.

In any event, the fundamental point is that "'[t]he United States are as much bound by their contracts as are individuals. If they repudiate their obligations, it is as much repudiation, with all the wrong and reproach that term implies, as it would be if the repudiator had been a State or a municipality or a citizen.'" *Perry* v. *United States*, 294 U.S. 330, 351 (1935) (quoting *Union Pac. R.R.* v. *United States*, 99 U.S. 700, 719 (1878)). And when the United States breaches its obligations, the consequences for the parties are to be governed by general principles of contract law, not *sui generis* contract rules devised by the Federal Circuit. See, *e.g.*, *Winstar*, *supra*. The Federal Circuit's departure from these principles, occurring in an area where its jurisdiction is exclusive and its holding has legal consequences of national significance — and involving a case where the government's breach of contract cost petitioners almost half a billion dollars — warrants this Court's review.

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted.

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APPENDIX A
[Revised Opinion of the United States Court of Appeals For the Federal Circuit (Sept. 13, 2007)]

United States Court of Appeals, Federal Circuit

The LONG ISLAND SAVINGS BANK, FSB, and The Long Island Savings Bank of Centereach FSB, Plaintiffs-Appellees,

v.

UNITED STATES, Defendant-Appellant.

No. 2006-5029

Sept. 13, 2007

Before MAYER, GAJARSA, and LINN, Circuit Judges.

GAJARSA, Circuit Judge.

In this *Winstar*-related case, the United States appeals a decision of the United States Court of Federal Claims granting a motion for summary judgment by the Long Island Savings Bank, FSB ("LISB") and the Long Island Savings Bank of Centereach FSB ("Centereach") on the government's counterclaim and affirmative defenses. *Long Island Sav. Bank, FSB* v. *United States ("LISB Summ. J.")*, 54 Fed. Cl. 607 (2002). The United States also appeals the decision of the Court of Federal Claims after trial awarding breach of contract damages to LISB and Centereach in the amount of $435,755,000. *Long Island Sav. Bank, FSB* v. *United States ("LISB Trial")*, 67 Fed. Cl. 616 (2005).

On February 1, 2007, this court held the banks' claims against the government to be forfeited under 28 U.S.C. § 2514 and thus reversed. *Long Island Sav. Bank, FSB* v. *United States*, 476 F.3d 917 (Fed. Cir. 2007). The banks filed a combined petition for panel rehearing and rehearing en banc; a response thereto was invited by the court and filed by the government. Acting en banc, the court returned the case to the original panel for revision.

Accordingly, the previous opinion of the court in this appeal, issued on February 1, 2007, and reported at 476 F.3d 917, is withdrawn and vacated. Because we hold that the contract is tainted from its inception by fraud and thus void ab initio, and that the claims against the government are excused by prior material breach, we reach the same disposition as our previous opinion and reverse the decision of the Court of Federal Claims.

I.

This case is another of the many *Winstar*-cases arising from the savings and loan crisis of the 1980s. See generally *United States* v. *Winstar Corp.*, 518 U.S. 839 (1996). The facts and procedural history pertinent to this appeal follow.

A. The Parties and the Contract

In April 1982, the Federal Savings and Loan Insurance Corporation ("FSLIC") created Suffolk County Federal Savings and Loan Association ("Suffolk County") by merging two thrifts on Long Island that were incurring significant operating losses. *LISB Trial*, 67 Fed. Cl. at 619. In October 1982, FSLIC undertook a national solicitation for potential acquirers of Suffolk County because its financial condition continued to decline. *Id.* at 620.

FSLIC determined that of the six bids received, the bid from LISB, a conservatively run and healthy thrift bank with branches in New York state, was the most favorable. *Id.* at 621. Specifically, "FSLIC had determined that LISB's bid was the most attractive of all bids, both because it proposed the least amount of financial assistance from FSLIC and because FSLIC was attracted by LISB's *proven record of sound financial management.*" Compl. ¶ 24 (emphasis added). Negotiations began, and the parties executed a final Assistance Agreement on August 17, 1983. *LISB Trial*, 67 Fed. Cl. at 619.

Pursuant to the Assistance Agreement, Suffolk County converted "from a federal mutual savings and loan association into a federal stock savings bank" and changed its name to Centereach, and LISB acquired Centereach as a wholly owned subsidiary by purchasing 100% of Centereach's authorized common stock for $100,000. Assistance Agreement at 1. The agreement required the government to make a direct cash contribution of $75 million to Centereach's net worth account within three business days of the conversion and acquisition. *Id.* § 3. In total, the government infused $122 million into Centereach under the Assistance Agreement and related agreements. *LISB Summ. J.*, 54 Fed. Cl. at 610. In addition, the government agreed that LISB and Centereach could use "the accounting principles in effect for mergers and acquisitions prior to the issuance of FASB # 72" to account for the acquisition. Assistance Agreement § 10. Those accounting principles enabled Centereach to account for approximately $625.4 million of goodwill to be amortized over forty years by the straight-line method. *LISB Trial*, 67 Fed. Cl. at 622. See generally *Winstar*, 518 U.S. at 853-56,

(describing goodwill accounting allowed by FSLIC and advantages to acquiring institutions).

The Assistance Agreement explicitly conditioned the government's obligations on, inter alia, the "receipt of a certificate, dated as of the Purchase Date, signed by the Chairman of the Board of LISB," who as discussed infra Part I.B was James J. Conway, Jr., stating that:

(A) The representations and warranties of LISB set forth in § 11(b) are true and substantially correct as of the Purchase Date; and

(B) No event has occurred and is continuing on the Purchase Date which would constitute, or which with notice or lapse of time or both would constitute, a Breach.

Assistance Agreement § 2(c)(7). Of pertinence here, LISB represented and warranted in section 11(b)(5) the following:

> *Compliance With Law.* Except as disclosed in Exhibit G, *LISB is not in violation of any applicable statutes, regulations* or orders of, or any restrictions imposed by, the United States of America or any state, municipality or other political subdivision or any agency of the foregoing public units, regarding the conduct of its business and the ownership of its properties, including, without limitation, all applicable statutes, regulations, orders and restrictions relating to savings and loan associations, equal employment opportunities, employment retirement income security, and environmental standards and controls where such violation would materially and adversely affect LISB's

> business, operations or condition, financial or otherwise.

(Emphasis added). LISB also represented and warranted in section 11(b)(9):

> *Material Facts.* This Agreement and all information furnished by LISB in connection with this Agreement or the Master Agreement do not contain any untrue statement of a material fact or omit to state a material fact necessary to be stated in order to make the statements contained therein not misleading; and there is no fact which materially adversely affects or in the affect the business operation, affairs or condition, financial or otherwise, of LISB or any of its properties or assets which has not been set forth in this Agreement, the Master Agreement or the other documents furnished under either Agreement.

(Emphasis added). It is undisputed that LISB's Chairman certified to the government that the "representations and warranties of LISB set forth in § 11(b) are true and substantially correct" as required by section 2(c)(7) of the Assistance Agreement.

Section 16 specified that "[t]his Agreement and the rights and obligations under it shall be governed by the law of the State of New York to the extent that Federal law does not control."

B. Conway and his Law Firm Compensation

LISB and Centereach entered into the Assistance Agreement through their Chairman of the Board of Trustees and CEO James J. Conway, Jr. Assistance

Agreement at 31. During his tenure at LISB and Centereach, Conway also received compensation from the law firm Conway & Ryan. The banks agree that Conway & Ryan was their "primary outside counsel" that "performed mortgage closing services and occasionally represented [LISB] in foreclosure proceedings," and that a "substantial portion" of the law firm's revenues were from the banks' mortgage closing services. The parties' summary judgment submissions show that the law firm, starting in 1980 and ending with the firm's dissolution in 1992, derived at least 70% of its revenues from LISB. "From 1982 to 1991, Conway caused LISB to utilize the firm as LISB's sole mortgage closing counsel, and he ensured that the firm had the exclusive right to represent LISB in connection with all mortgage closings without action from the Board." *LISB Summ. J.*, 54 Fed. Cl. at 610.

Conway, an attorney admitted to the New York state bar, had worked for the law firm since 1953. Conway became a member of LISB's Board of Trustees in 1966 and the Chairman in 1976. In 1980, Conway received two legal opinions, one provided unsolicited by a partner at the law firm and one solicited by Conway from an outside attorney, stating that New York law prohibited him from receiving compensation from the law firm for legal services relating to any of the banks' loans.

In January 1982, the Board elected Conway to be LISB's CEO. After becoming CEO of LISB, Conway stopped practicing law and engaging in other professional services for the law firm. However, Conway continued to receive compensation from the law firm, and the banks agree that "Conway's compensation included revenues received by [the law

firm] for performing" the "banks' mortgage closing services." From September 1975, when Conway & Ryan was incorporated as a New York professional corporation, to December 1984, Conway owned 65% of the law firm. Accordingly, Conway received at least 60% of the law firm's income for the fiscal years ending in August 1981, 1982, and 1983.

In December 1984, Conway reduced his ownership interest to 9% by, in part, transferring 51% of the law firm to his daughter. Around that time, Conway had become aware of a thrift regulation restricting his ownership interest in the law firm to less than 10%. Conway retained his 9% ownership interest until December 1989. Conway, his daughter, and his daughter-in-law collectively, however, continued to own at least 60% of the law firm. Accordingly, while Conway received between 9% and 40% of the law firm's annual income after 1984, Conway, his daughter, and his daughter-in-law collectively received at least 60% annually, except for the fiscal year ending in August 1985 when they received 51%.

Between 1980 and 1989, Conway personally received at least $3.5 million from the law firm. Collectively, Conway, his daughter, and his daughter-in-law received at least $10.9 million from the law firm during the same time period.

While there were multiple opportunities to disclose this continuing financial distribution, neither Conway nor LISB disclosed the compensation from the law firm during this time period. In December 1981, LISB "applied for conversion from a state-chartered mutual savings bank to a Federal mutual savings bank charter." To determine eligibility for conversion, the Federal

Home Loan Bank Board ("FHLBB") required LISB to answer a management questionnaire, and LISB's president "stated that he [wa]s aware that approval of the application to convert w[ould] require that [LISB] adhere to various Federal and Insurance Regulations." LISB submitted, inter alia, the following responses (in italics, underlined emphasis added) in February 1982.

> 6. List each enterprise doing business with the institution in which any of the institution's personnel have a direct or indirect interest. If such enterprise has had any business transactions with the institution since the last examination, indicate the nature of the interest and the volume and type of business involved. If the association provides space, employees, equipment, services, or expenses, explain the arrangement in full.
>
> *Officer James J. Conway, Jr. retains an interest in a law firm that presently renders service to the Bank and receives remuneration from outside income of said firm.*
>
> * * *
>
> 9. List any affiliated person of the institution who receives any commission, fee, or rebate from outside sources, or benefits, directly or indirectly, from financing or any other business placed through, by, or with the institution, if such information has not been furnished in response to questions six (6), seven (7), and eight (8). Name such persons and state the amount and purpose of, and the

basis and reasons for, such disbursements, credits or other benefits.

NONE

In February 1983, July 1984, and April 1986, LISB submitted the same answers regarding Conway in response to subsequent FHLBB examinations. In December 1987, FHLBB employed a different management questionnaire, but LISB continued to respond that Conway "retains an interest in a law firm that presently renders service to the Bank and *receives remuneration from outside income of said firm*." (emphasis added).

In its summary judgment briefs to the Court of Federal Claims and on appeal, the government submitted an affidavit from the government's supervisory agent responsible for recommending whether LISB's acquisition of Centereach should be approved in 1983. The affidavit stated that:

> Had Mr. Conway correctly and accurately revealed the nature and substance of the kickback scheme and/or the fact that Mr. Conway was violating the RESPA anti-kickback provision prior to and during negotiations with the FSLIC and FHLBB for the Suffolk acquisition, I would have recommended that we discontinue discussions and negotiations with [LISB] regarding its acquisition of Suffolk, and I would have recommended that [LISB] be removed as a bidder for Suffolk and or any other supervisory acquisition. I also would not have recommended that [LISB] be permitted to purchase Suffolk.

Vigna Aff. ¶ 14. The affidavit also stated that "FSLIC and FHLBB would not provide financial or regulatory assistance to acquirers engaged in the type of serious impropriety at issue in this case." *Id.* ¶ 15.

C. Enactment of *FIRREA*

On August 9, 1989, the Government enacted the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 ("FIRREA"), Pub. L. No. 101-73, 103 Stat. 183 (1989), which restricted Centereach's ability to count supervisory goodwill and capital credit toward compliance with its tangible capital requirement. As the Supreme Court noted in *Winstar*, 518 U.S. at 857, "[t]he impact of FIRREA's new capital requirements upon institutions that had acquired failed thrifts in exchange for supervisory goodwill was swift and severe." Many institutions fell out of compliance and were either seized by government regulators or stayed in business only after "massive private recapitalization." *Id.* at 857-58.

"With FIRREA, Centereach's capital ratio plummeted from more than 8% positive to a negative 11%." *LISB Trial*, 67 Fed. Cl. at 623. In addition, the Federal Deposit Insurance Corporation Improvement Act of 1991 ("FDICIA"), Pub. L. No. 102-242, 105 Stat. 2236 (1991), established sanctions through regulation to institutions deemed undercapitalized. The management of LISB and Centereach thus embarked on a restructuring plan, which involved selling branches, securities, and loans, paying down other borrowings, merging LISB and Centereach, and writing off goodwill. *LISB Trial*, 67 Fed. Cl. at 625, 627-28.

Several institutions sued the government "[b]elieving that [FHLBB] and FSLIC had promised them that the supervisory goodwill created in their merger transactions could be counted toward regulatory capital requirements," and the Supreme Court subsequently held in *Winstar* that neither the canon of unmistakeability nor the doctrine of sovereign acts prevented the government from being liable for breaching contracts by subsequently changing the relevant law. 518 U.S. at 843, 858, 860.

D. Complaint Against the Government, the Discovery of Conway's Law Firm Compensation, and the Government's Affirmative Defenses

With the enactment of FIRREA, Conway, as Chairman of the Board of Trustees and CEO of the banks, hired an outside law firm to advise the banks. See *Doe* v. *Poe*, 595 N.Y.S.2d 503, 189 A.D.2d 132 (N.Y. App. Div. 1993). In February 1990, Conway, the banks' president, the outside law firm, and another outside law firm that Conway had hired for the banks met to discuss a lawsuit by the banks against the government. The outside law firms "suggested that, in preparation for the pending Federal litigation and upcoming regulatory inspections, they conduct a 'due diligence' inquiry to determine whether the bank[s were] in compliance with all regulatory requirements." Conway and the president of the banks agreed. See *id.* at 503-04. In two meetings that year, the outside law firms discovered the law firm compensation that Conway was receiving and in August 1990, advised Conway to retain his own counsel. See *id.* at 504. "Sometime thereafter, a special committee of the

bank[s'] board of trustees was formed to investigate the relationship between [Conway], his family, and his former law firm." *Id.* Conway filed suit in New York state court to enjoin the outside law firms from disclosing to the committee the information learned from the meetings based on attorney-client privilege. See *id.* at 504.

In June 1992, Conway resigned from LISB and Centereach. In August 1992, LISB and Centereach filed a complaint against the government in the Court of Federal Claims alleging that the government breached its contractual obligations by enacting FIRREA. According to the banks, "[i]n September 1992, the [New York state] court rejected Conway's claim [seeking to enjoin the outside law firms from disclosing the information to the banks]. The Banks immediately informed OTS upon learning the facts of Conway's relationship with [his law firm]." Appellee Br. 42.

In February 1993, OTS commenced an investigation into Conway's law firm compensation. Based on its findings, OTS concluded that Conway "engaged in violations of federal conflict-of-interest and disclosure regulations, participated in conflicts of interest constituting an unsafe or unsound practice within the meaning of 12 C.F.R. § 571.7, and breached his fiduciary duty owed to LONG ISLAND SAVINGS." J.A. 300455. In February 1994, "while neither admitting or denying the OTS' findings and conclusions," Conway entered into a consent order with OTS in which Conway stipulated and consented to the order banning him from the thrift and banking industry and requiring him to pay $1.3 million in restitution to LISB. J.A. 300456-57.

In February 1998, Conway pled guilty to a criminal misdemeanor information charging him with violating 18 U.S.C. § 215.[1] Specifically, Conway agreed with the following facts: "[i]n his capacity as chief executive officer and Chairman of LISB, ... [Conway] influenced whether LISB continued to use the law firm as its legal counsel for residential mortgage closings"; "[f]rom 1983 through 1989, while holding his executive LISB positions, [Conway] received $3,194,103.87 in compensation from the law firm"; and "[i]n or about and between September 3, 1986, and October 30, 1987, ... [Conway] knowingly, intentionally and corruptly solicit[ed], demanded, accepted and agreed to accept ... funds from the law firm paid directly to him, ... intending to be influenced and rewarded in connection with ... the assignment of the LISB residential mortgage closing work to the law firm."

This conviction led the New York Supreme Court, Appellate Division, to disbar Conway for professional misconduct in August 2000. *In re Conway*, 712 N.Y.S.2d 610, 275 A.D.2d 24 (N.Y. App. Div. 2000). Specifically, the court found:

> The mitigating circumstances proffered by the respondent notwithstanding, the fact remains that, while chairman of the board and chief executive officer of a savings bank, he engaged in a scheme of illegal kickbacks, using his daughter and daughter-in-law as conduits to circumvent Federal law prohibiting him from receiving compensation

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[1] 18 U.S.C. § 215 is a criminal statute governing the receipt of commissions or gifts for procuring loans by an "officer, director, employee, agent, or attorney of a financial institution."

> from his former law firm, which relied on the bank for approximately 90% of its business. The payments were substantial, totalling [sic] more than three million dollars. Such misconduct, which went on for several years, can hardly be deemed aberrational.

Id. at 611.

In February 2001, the government filed its answer to the complaint in the Court of Federal Claims. The government's answer included affirmative defenses and counterclaims asserting forfeiture of the plaintiffs' claims and rescission of the contract "because the thrifts committed fraud in the inducement as well as fraud in the performance of the alleged contract." Answer ¶¶ 175-84. According to the government, it submitted this filing-answer, affirmative defenses, and counterclaims-before the time negotiated by the parties. See U.S. Summ. J. Reply 38-41 (May 30, 2001) (detailing stay of *Winstar*-related cases pending Supreme Court decision and Omnibus Case Management Order stating in part that the government (a) in responding to plaintiffs' summary judgment motion "need not identify any defenses of any kind, counterclaims, set-offs, pleas in fraud" and that "the failure to assert those defenses in its response will not constitute a waiver" and (b) "shall not file an answer to the complaint in any case, and no defenses or arguments of any kind shall be deemed waived by reason of defendant's not having filed an answer to any complaint"). The record indicates that the banks do not dispute this procedural history. See Pls.' Summ. J. Surreply 20-21 (Jun. 18, 2001) (discussing timeliness without disputing government's representation of procedural history).

E. Proceedings Before the Court of Federal Claims

On December 9, 2002, the Court of Federal Claims decided in favor of LISB and Centereach on the parties' cross-motions for summary judgment on the government's affirmative defenses and counterclaims. *LISB Summ. J.*, 54 Fed. Cl. 607. Specifically, the Court of Federal Claims found that "Conway and his firm's status as 'affiliated persons' did not cause LISB to be in violation of the Assistance Agreement," *id.* at 612-14; that it "cannot conclude that LISB, as a corporate entity, acted fraudulently," *id.* at 614-18; and that Conway's conflict-of-interest conduct could not be imputed to LISB, *id.* at 618-19. The Court of Federal Claims thus rejected the government's summary judgment motion asserting that "(1) plaintiffs' claims are forfeited under a special plea in fraud pursuant to 28 U.S.C. § 2514; (2) common law fraud renders the contract unenforceable; (3) the contract should be rescinded and $122 million repaid to the Government; and (4) plaintiffs' prior material breach precludes damages." *LISB Summ. J.*, 54 Fed. Cl. at 609.

On September 15, 2005, after a twenty-four day trial, post-trial briefing, and closing arguments, the Court of Federal Claims issued its opinion and order holding the government liable and awarding $435,755,000 in damages to LISB and Centereach. *LISB Trial*, 67 Fed. Cl. at 618.

The government appeals the granting of summary judgment regarding its affirmative defenses in favor of LISB and Centereach in *LISB Summ. J.* and the determination of damages in *LISB Trial*. The Court of Federal Claims exercised

jurisdiction pursuant to the Tucker Act, 28 U.S.C. § 1491(a)(1), and entered final judgment on September 30, 2005. We have jurisdiction pursuant to 28 U.S.C. § 1295(a)(3).

II.

The Court of Federal Claims applies the same summary judgment standard as that of federal district courts: summary judgment is proper if the evidence demonstrates that "there is no genuine issue as to any material fact and that the moving party is entitled to a judgment as a matter of law." See Ct. Fed. Cl. R. 56(c); Fed. R. Civ. P. 56(c); see also *Celotex Corp.* v. *Catrett*, 477 U.S. 317, 322-23 (1986); *SmithKline Beecham Corp.* v. *Apotex Corp.*, 403 F.3d 1331, 1337 (Fed. Cir. 2005). Therefore, we review a grant of summary judgment by the Court of Federal Claims de novo, drawing justifiable factual inferences in favor of the party opposing the judgment. *SmithKline*, 403 F.3d at 1337; *Winstar Corp.* v. *United States*, 64 F.3d 1531, 1539 (Fed. Cir. 1995) (en banc). Once the moving party has satisfied its initial burden, the opposing party must establish a genuine issue of material fact and cannot rest on mere allegations, but must present actual evidence. *Anderson* v. *Liberty Lobby, Inc.*, 477 U.S. 242, 248 (1986). Issues of fact are genuine only "if the evidence is such that a reasonable jury could return a verdict for the nonmoving party." *Id.*

III.

A. Federal Common Law Fraud

The government asserted that the plaintiffs committed fraud in the inducement as well as fraud in the performance of the contract and that federal common law renders the Assistance Agreement

unenforceable. Answer ¶¶ 175-81; U.S. Summ. J. Mot. 31-47 (Apr. 17, 2001); *LISB Summ. J.*, 54 Fed. Cl. at 609, 615. The plaintiffs asserted that there was neither fraud in the inducement nor fraud in the performance of the Assistance Agreement and that any counterclaims and affirmative defenses based on common law fraud fail. Pls.' Summ. J. Mem. 41-55 (May 3, 2001). The Court of Federal Claims agreed with the plaintiffs. *LISB Summ. J.*, 54 Fed. Cl. at 620. We reverse.

Procedurally, while the parties' briefs to this court could appear to focus on the government's special plea in fraud under 28 U.S.C. § 2514, the issue of federal common law fraud is properly before this court. In *City of Sherrill* v. *Oneida Indian Nation*, 544 U.S. 197 (2005), the Supreme Court "resolve[d] th[e] case on considerations not discretely identified in the parties' briefs," stating that the question addressed "is inextricably linked to, and is thus 'fairly included' within, the questions presented." *Id.* at 214 n. 8; see also *Connor* v. *Finch*, 431 U.S. 407, 421 n. 19 (1977) (stating that issues may "appropriately be viewed as an issue implicitly raised by the parties"). In this case, the parties' briefs to the Court of Federal Claims and the opinion of the Court of Federal Claims meshed fraud under 28 U.S.C. § 2514 together with fraud under common law. Indeed, the Court of Federal Claims evaluated the elements of common law fraud as the elements of § 2514. *LISB Summ. J.*, 54 Fed. Cl. at 615.

Similarly, in the government's brief to this court, the pertinent issue presented is "[w]hether the trial court erred, as a matter of law, in refusing to impute knowledge of fraud in the inducement of a Government contract from the chairman and chief

executive officer of the plaintiff, Long Island Savings Bank, FSB ('LISB'), to the institution itself." Appellant Br. 2 (emphasis added).

Therefore, to the extent that the government's defense based on federal common law fraud was not explicitly appealed, we find that the defense "is inextricably linked to, and is thus 'fairly included' within, the questions presented." *Sherrill*, 544 U.S. at 214 n. 8. Moreover, under these circumstances, we can exercise our discretion to apply federal common law in this case. *Kamen* v. *Kemper Fin. Servs., Inc.*, 500 U.S. 90, 99 (1991) ("When an issue or claim is properly before the court, the court is not limited to the particular legal theories advanced by the parties, but rather retains the independent power to identify and apply the proper construction of governing law."); *Becton Dickinson & Co.* v. *C.R. Bard, Inc.*, 922 F.2d 792, 800 (Fed. Cir. 1990) (stating that "practice of [waiving an issue not raised by an appellant in its opening brief] is, of course, not governed by a rigid rule but may as a matter of discretion not be adhered to where circumstances indicate that it would result in basically unfair procedure"); *cf. Harris Corp.* v. *Ericsson Inc.*, 417 F.3d 1241, 1251-52 (Fed. Cir. 2005) (stating that "[a]n appellate court retains case-by-case discretion over whether to apply waiver," and holding that claim construction arguments "advocating the same concept" are properly addressed). Therefore, we proceed to evaluate the merits of the government's common law fraud assertion.

The Supreme Court has stated that "[w]hen the United States enters into contract relations, its rights and duties therein are governed generally by the law applicable to contracts between private

individuals." *Winstar*, 518 U.S. at 895. The Court has also stated that "[i]t is customary, where Congress has not adopted a different standard, to apply to the construction of government contracts the principles of general contract law," *Priebe & Sons, Inc.* v. *United States*, 332 U.S. 407, 411 (1947), "which become federal common law," *Fomby-Denson* v. *Dep't of Army*, 247 F.3d 1366, 1373-74 (Fed. Cir. 2001). In this case, the parties have not asserted that Congress has adopted a standard other than federal common law. Indeed, the parties recognized the governing role of federal common law in the Assistance Agreement, which states in section 16 that "[t]his Agreement and the rights and obligations under it shall be governed by the law of the State of New York to the extent that Federal law does not control." In short, federal common law governs this action.

The Restatement of Contracts reflects many of the contract principles of federal common law. *Cf. Mobil Oil Exploration & Producing Se., Inc.* v. *United States*, 530 U.S. 604, 608 (2000) (relying similarly on the Restatement of Contracts for principles of repudiation and restitution); *Franconia Assocs.* v. *United States*, 536 U.S. 129, 141-43 (2002) (applying principles of general contract law by relying in part on Restatement (Second) of Contracts (1979) to determine whether contract claim against federal government was within Tucker Act statute of limitations). As set forth in the Restatement of Contracts, a misrepresentation may prevent the formation of a contract or may make a contract voidable. See Restatement (Second) of Contracts §§ 163-64 (1981). The difference between the former and the latter is sometimes referred to as the difference between misrepresentations that make a

contract "void" versus "voidable." See *id.* § 7 cmt. a, § 163 cmt. c.

We have stated that "the general rule is that a Government contract tainted by fraud or wrongdoing is void *ab initio*." *Godley* v. *United States*, 5 F.3d 1473, 1476 (Fed. Cir. 1993) (citing *United States* v. *Miss. Valley Generating Co.*, 364 U.S. 520, 564, (1961), and *J.E.T.S., Inc.* v. *United States*, 838 F.2d 1196, 1200 (Fed. Cir. 1988)).[2] We established this rule in *J.E.T.S.*, which held that a government contractor's false certification barred its subsequent claim. 838 F.2d at 1197. Specifically, we stated:

> The contract which, according to the Board's decision in the first case, the government constructively had changed, was procured by and therefore permeated with fraud. As discussed in part III below, J.E.T.S. obtained this contract by knowingly falsely stating that it was a small business. Had it stated the truth about its size, it would not have received the contract. A government contract thus tainted from its inception by fraud is void ab initio, like the government contracts held void because similarly tainted by a prohibited conflict of interest in *United States* v. *Mississippi Valley Generating Co.*, 364 U.S. 520, 81 S.Ct. 294, 5 L.Ed.2d 268 (1961), and *K & R Eng'g Co.* v. *United States*, 616 F.2d 469, 222 Ct.Cl. 340 (1980).

J.E.T.S., 838 F.2d at 1200. Therefore, to prove that a government contract is "tainted from its inception

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[2] But see *United States* v. *Jamieson Sci. & Eng'g, Inc.*, 214 F.3d 1372, 1377 (D.C. Cir. 2000) (disagreeing with *J.E.T.S.* and *Godley*).

by fraud" and is thus "void ab initio," the government must prove that the contractor (a) obtained the contract by (b) knowingly (c) making a false statement. We address these elements in reverse order.

1. *False statement*

In *J.E.T.S.*, we affirmed the Board's decision that the government contractor falsely certified that it was a small business. 838 F.2d at 1201. Similarly, in this case, the government asserts that LISB falsely certified that the "representations and warranties of LISB set forth in § 11(b) [we]re true and substantially correct as of the Purchase Date." Specifically, section 2(c)(7) of the Assistance Agreement conditioned the government's obligations on the receipt of a certificate "signed by the Chairman of the Board of LISB stating" that the "representations and warranties of LISB set forth in § 11(b) are true and substantially correct as of the Purchase Date" and that "[n]o event has occurred and is continuing on the Purchase Date which would constitute, or which with notice or lapse of time or both would constitute, a Breach." It is undisputed that Conway as Chairman and CEO of LISB[3] had the authority to submit the certification and did so. *LISB Summ. J.*, 54 Fed. Cl. at 615-16. In addition, there is no dispute that Conway's conduct in submitting the certification should be imputed to

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[3] Neither LISB nor Centereach has raised any issues regarding the Assistance Agreement requiring the certification of the Chairman of LISB but not of Centereach. Indeed, for purposes of the government's counterclaims and affirmative defenses, all of the parties have treated LISB and Centereach as the same in this appeal. Therefore, we do so as well.

LISB, and the certification required by section 2(c)(7) constituted a statement to the government.

The falsity of the certification depends on the representation and warranty provisions of the contract. LISB represented and warranted in section 11(b)(5) of the Assistance Agreement that it was "not in violation of any applicable statutes, regulations or orders." The government argued on appeal that the contract thus required LISB to comply with 12 C.F.R. § 563.17(a) (1984), which provided that LISB and Centereach "shall maintain safe and sound management." In addition, the regulations charged FHLBB with "the enforcement of laws, regulations, or conditions against ... the officers or directors,"12 C.F.R. § 500.3 (1984), and FHLBB required that officers refrain from breaching fiduciary duties involving personal profit, see 12 C.F.R. § 563.39 (1984) ("Termination for cause shall include termination because of ... breach of fiduciary duty involving personal profit.").

In this case, the Court of Federal Claims found that "Conway and his firm's impropriety under banking laws is evident." *LISB Summ. J.*, 54 Fed. Cl. at 614. Similarly, "based on its findings from the Investigation, the OTS" concluded that Conway "breached his fiduciary duty owed to" LISB. As a result, Conway consented to an order that banned him from the thrift and banking industry and that required him to pay $1.3 million in restitution and reimbursement to LISB. The banks concede that Conway's compensation from the law firm during the time he was Chairman and CEO of LISB and Centereach, between at least 1982 and 1989, "included revenues received by [the law firm] for performing" the "banks' mortgage closing services."

Moreover, by pleading guilty to violating 18 U.S.C. § 215, Conway admitted that he committed a crime by corruptly accepting $3,194,103.87 in compensation from the law firm intending to be influenced and rewarded for "the assignment of the LISB residential mortgage closing w rk to the law firm." Therefore, we agree that Conway breached his fiduciary duties to LISB and Centereach and profited personally from that breach.

Nonetheless, the Court of Federal Claims found that LISB was not operating in an unsafe and unsound manner under 12 C.F.R. § 563.17. The Court of Federal Claims reasoned that "had Conway not accepted compensation related to mortgage closing services of LISB's borrowers, but the relationship between LISB and the firm was otherwise the same, no impropriety would exist." *LISB Summ. J.*, 54 Fed. Cl. at 614. By focusing solely on the relationship between LISB and the law firm, the Court of Federal Claims improperly ignored the relationship between Conway and both LISB and Centereach. Specifically, the Chairman of the Board and CEO of LISB and Centereach breached his fiduciary duties for personal profit. This is not safe and sound management. Even if it were unclear whether Conway's conduct precluded a finding of safe and sound management, LISB represented and warranted in section 11(b)(9) of the Assistance Agreement that it would not "omit to state a material fact necessary to be stated in order to make the statements contained therein not misleading." At a minimum, Conway's conduct was a material fact necessary to make LISB's section 11(b)(5) representation and warranty of compliance with law, including safe and sound management, not misleading.

Therefore, LISB's certification to the government regarding the "true and substantially correct" nature of the representations and warranties made in the Assistance Agreement was false.

2. *Knowledge*

The Court of Federal Claims found that "[a]lthough LISB knew Conway was being compensated by his firm, this Court cannot conclude that [others at] LISB knew that the arrangement was improper, and, therefore, a misrepresentation." *LISB Summ. J.*, 54 Fed. Cl. at 616-17. We see no error in this factual conclusion.

The critical inquiry thus becomes whether Conway had knowledge of the certification's falsity and if so, whether such knowledge may be imputed to LISB.

a. Knowledge of falsity

The Court of Federal Claims found that Conway entered into the Assistance Agreement "knowing his conflicting dual relationship with his firm and LISB prohibited him from entering into the Assistance Agreement and from receiving compensation from his firm." *LISB Summ. J.*, 54 Fed. Cl. at 615-16. We agree. First, as discussed, Conway certified under the Assistance Agreement that there were no omissions of material fact regarding LISB's compliance with the law, including the regulation requiring "safe and sound management," that would mislead the government. Second, Conway received two legal opinions before submitting the Assistance Agreement certification stating that he was legally prohibited from receiving compensation from the law firm for legal services relating to any of the banks' loans. Third, the banks concede that Conway's

compensation from the law firms during the time he was Chairman and CEO of LISB and Centereach, between at least 1982 and 1989, "included revenues received by [the law firm] for performing" the "banks' mortgage closing services."

Our conclusion is further supported by the facts surrounding the Assistance Agreement. Neither Conway nor LISB accurately disclosed the compensation from his law firm when prompted by the government in February 1982, February 1983, July 1984, April 1986, or December 1987. In each instance, LISB responded that Conway "retains an interest in a law firm that presently renders service to the Bank and receives remuneration from outside income of said firm." This was false because, as the banks concede, Conway' compensation from the law firm "included revenues received by [the law firm] for performing" the "banks' mortgage closing services." In pleading guilty, Conway also admitted that: "[i]n his capacity as chief executive officer and Chairman of LISB, ... [Conway] influenced whether LISB continued to use the law firm as its legal counsel for residential mortgage closings"; "[f]rom 1983 through 1989, while holding his executive LISB positions, [Conway] received $3,194,103.87 in compensation from the law firm"; and "[i]n or about and between September 3, 1986, and October 30, 1987, ... [Conway] knowingly, intentionally and corruptly solicit[ed], demanded, accepted and agreed to accept... funds from the law firm paid directly to him, ... intending to be influenced and rewarded in connection with ... the assignment of the LISB residential mortgage closing work to the law firm." LISB and Centereach attempt to minimize the significance of Conway's guilty plea, citing to his trial testimony in this case where he explained that he

pled to protect his children. However, "a party cannot simply contradict an earlier sworn statement," and there is no credible evidence here supporting the contradiction. *Cf. Gemmy Indus. Corp.* v. *Chrisha Creations Ltd.*, 452 F.3d 1353, 1359 (Fed. Cir. 2006) (finding summary judgment grant improper where credible evidence supported contradiction).

In addition, when the banks' outside counsel, ironically hired by Conway himself, discovered Conway's law firm compensation, Conway attempted but failed to enjoin the outside counsel from disclosing the information to the banks and the government regulators. See *Doe* v. *Poe*, 595 N.Y.S.2d at 504-05.

Therefore, the record demonstrates that Conway had knowledge of the certification's falsity.

b. Imputation of knowledge

While we apply the principles of general contract law to the construction of government contracts, whether federal common law or state law applies to imputation of knowledge is a separate question. In this case, however, we need not decide this choice of law question because we can resolve the issue of knowledge imputation based on legal principles common to both federal and state law.

Under the general common law of agency, "[e]xcept where the agent is acting adversely to the principal ..., the principal is affected by the knowledge which an agent has a duty to disclose to the principal ... to the same extent as if the principal had the information." Restatement (Second) of Agency § 275 (1958); *cf. Comty. For Creative Non-Violence* v. *Reid*, 490 U.S. 730, 751-52 (1989) (relying

on Restatement (Second) of Agency to determine whether hired party is employee under general common law of agency for Copyright Act purposes). Similarly, the Restatement (Second) of Agency § 282 (1958) specifies that a "principal is not affected by the knowledge of an agent in a transaction in which the agent secretly is acting adversely to the principal *and entirely for his own or another's purposes*" (emphasis added). Regarding the emphasized language, the "mere fact that the agent's primary interests are not coincident with those of the principal does not prevent the latter from being affected by the knowledge of the agent if the agent is acting for the principal's interests." Restatement (Second) of Agency § 282 cmt. c.

The state law of New York has similar standards.

> In general, knowledge acquired by an agent acting within the scope of his or her agency is imputed to the principal and the latter is bound by that knowledge even if the information is never actually communicated. An exception to this rule occurs when the agent has abandoned his or her principal's interests *and is acting entirely for his or her own or another's purposes.*

Christopher S. v. *Douglaston Club*, 713 N.Y.S.2d 542, 275 A.D.2d 768 (N.Y. App. Div. 2000) (citing *Center* v. *Hampton Affiliates, Inc.*, 488 N.E.2d 828, 829-30, 66 N.Y.2d 782 (N.Y. 1985)) (emphasis added). The adverse interest exception "cannot be invoked merely because he has a conflict of interest or because he is not acting primarily for his principal." *Center*, 488 N.E.2d at 830 (citations omitted).

In this case, under the general rule of imputation, it is undisputed that Conway was an agent of the banks and had knowledge of his illegal compensation scheme. Therefore, the first step indicates that Conway's knowledge should generally be imputed to the banks, and the question becomes whether the adverse interest exception applies.

The Court of Federal Claims found that Conway "ha[d] abandoned his principal's interest and [wa]s acting to defraud his principal, entirely for his own or another's purpose" because "had the knowledge that the Government seeks to impute to LISB actually been disclosed to LISB, the success of Conway's scheme would have been impaired." *LISB Summ. J.*, 54 Fed. Cl. at 619. We do not agree with this analysis or its conclusion.

It is true that Conway pursued his own interests in his illegal compensation arrangement with his law firm. The mere fact that the agent's primary interests are not coincident with those of the principal, however, is not sufficient to invoke the adverse interest exception. Rather, both federal common law and New York state law require that the agent act "entirely for his own or another's purposes." Here, Conway's arrangement to refer all of LISB's mortgage closings to the law firm served at least two purposes: (1) to funnel to Conway a portion of the fees paid, which would have been paid regardless, by the principal's customers to the law firm; and (2) to obtain the proper legal services required by LISB for its mortgage closings. There was no evidence that the legal services were deficient. There was a clear benefit to LISB through this arrangement because the law firm was the bank's primary outside counsel, performed mortgage

closing services for and on behalf of the bank, and represented the bank in foreclosure proceedings. In addition, by signing the false certification under the Assistance Agreement, Conway enabled LISB to acquire Centereach under previously negotiated terms. In hindsight, LISB's interests probably would have been better served had Conway not perpetrated his illegal compensation arrangement, but the record fails to support the assertion that Conway entirely abandoned LISB's interests for his own. Therefore, Long Island cannot invoke the adverse interest exception because the CEO's conduct was not entirely for his own purposes, and the general rule applies imputing the agent's knowledge to the principal. As a matter of law, under both federal and state legal doctrines governing knowledge imputation, LISB and Centereach knew that the certification to the government was false.

3. *Causation*

In *Godley*, we emphasized that for a government contract to be tainted by fraud or wrong doing and thus void *ab initio*, the record must show some causal link between the fraud and the contract. *Godley*, 5 F.3d at 1476 (remanding because "this court cannot determine whether [the government agent's] illegal conduct caused any unfavorable contract terms"). In *J.E.T.S.*, the record demonstrated causation because "[h]ad [the government contractor] stated the truth about its size, it would not have received the contract." 838 F.2d at 1200.

Here, the Court of Federal Claims found that the "Government contracted for full disclosure of any conflicts-of-interest in order to assure the safe and

sound management of LISB, and it relied on Conway's statements. The Government thus justifiably relied on Conway's misrepresentation." 54 Fed. Cl. at 617. We agree.

In its summary judgment briefs to the Court of Federal Claims and on appeal, the government pointed to an affidavit from the government's supervisory agent responsible for recommending whether LISB's acquisition of Centereach should be approved in 1983. The affidavit stated that:

> *Had Mr. Conway correctly and accurately revealed the nature and substance of the kickback scheme* and/or the fact that Mr. Conway was violating the RESPA anti-kickback provision prior to and during negotiations with the FSLIC and FHLBB for the Suffolk acquisition, *I would have recommended that we discontinue discussions and negotiations with [LISB] regarding its acquisition of Suffolk, and I would have recommended that [LISB] be removed as a bidder for Suffolk and or any other supervisory acquisition. I also would not have recommended that [LISB] be permitted to purchase Suffolk.*

Vigna Aff. ¶ 14 (emphasis added); see also *id.* ¶ 15 ("The FSLIC and FHLBB would not provide financial or regulatory assistance to acquirers engaged in the type of serious impropriety at issue in this case."). Moreover, the active breaching of fiduciary duties by the Chairman of the Board and the CEO constitutes material information when the government (a) undertakes a national solicitation for potential acquirers of a declining financial institution; (b) contributes $75 million of cash to the

declining institution's net worth within days of the acquisition; (c) conditions performance on a representation and warranty of compliance with the law, including regulations requiring "safe and sound management"; and (d) conditions performance on a representation and warranty that there has been no omission of "a material fact necessary to be stated in order to make the statements contained therein not misleading." Under these circumstances, the only reasonable inference is that had the plaintiffs stated the truth about Conway, they would not have received the contract. The plaintiffs have set forth no affirmative evidence such that a reasonable jury could conclude otherwise. See *Anderson*, 477 U.S. at 248 (stating that issues of fact are genuine for summary judgment purposes only "if the evidence is such that a reasonable jury could return a verdict for the nonmoving party"). Indeed, the plaintiffs conceded in their complaint that "FSLIC had determined that LISB's bid was the most attractive of all bids, both because it proposed the least amount of financial assistance from FSLIC and *because FSLIC was attracted by LISB's proven record of sound financial management.*" Compl. ¶ 24 (emphasis added).

Accordingly, the government has proven that the plaintiffs obtained the contract by knowingly making a false certification. The Assistance Agreement was thus tainted at its inception by fraud and void *ab initio*.

B. Prior Material Breach

Even if the contract were not void, the doctrine of prior material breach precludes the plaintiffs' breach of contract claim for damages. We have stated:

> Under that doctrine, when a party to a contract is sued for breach, it may defend on the ground that there existed a legal excuse for its nonperformance at the time of the alleged breach. Faced with two parties to a contract, each of whom claims breach by the other, courts will "often ... impose liability on the party that committed the first material breach."

Barron Bancshares, Inc. v. *United States*, 366 F.3d 1360, 1380 (Fed. Cir. 2004); see also *Christopher Village, L.P.* v. *United States*, 360 F.3d 1319, 1334 (Fed. Cir. 2004). In both *Barron* and *Christopher Village*, we referenced § 237 cmt. b of the Restatement (Second) of Contracts (1981), which states:

> The rule is based on the principle that where performances are to be exchanged under an exchange of promises, each party is entitled to the assurance that he will not be called upon to perform his remaining duties of performance with respect to the expected exchange if there has already been an uncured material failure of performance by the other party.

See Barron, 366 F.3d at 1380-81; *Christopher Village*, 360 F.3d at 1334.

In this case, the government asserts, and we agree, that LISB's false certification constitutes an uncured material failure of performance that precludes the plaintiffs' claim for damages. First, because the Assistance Agreement explicitly conditioned the government's obligations on the receipt of a certificate "signed by the Chairman of the

Board of LISB stating" that the "representations and warranties of LISB set forth in § 11(b) are true and substantially correct as of the Purchase Date" and that "[n]o event has occurred and is continuing on the Purchase Date which would constitute, or which with notice or lapse of time or both would constitute, a Breach," the falsity of LISB's certification as discussed in supra Part III.A.1 represents a failure of performance. Second, based on our discussion of causation in *supra* Part III.A.3,[4] LISB's failure of performance is material. We have also noted "that our case law holds that any degree of fraud is material as a matter of law." *Christopher Village*, 360 F.3d at 1335. Third, because LISB's certification was a material condition precedent to the government's obligations, and because the Court of Federal Claims found that the government relied on the certification, LISB's failure of performance in uncured. See Restatement (Second) of Contracts § 242 (1981) (stating circumstances significant in "determining the time after which a party's uncured material failure to render or to offer performance discharges the other party's remaining duties to render performance"). Fourth, it is undisputed that LISB's false certification in 1983 preceded the government's breach with the enactment of FIRREA in 1989.

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[4] We note that the knowledge required for federal common law fraud making a contract void and discussed in *supra* Part III.A.2 is not required for prior material breach. See Restatement (Second) of Contracts § 235 (1981) cmt. a ("The defect need not be wil[l]ful or even negligent."); *id.* cmt. b ("When performance is due, however, anything short of full performance is a breach, even if the party who does not fully perform was not at fault.").

There is one wrinkle. We have held that "through its continued performance of the contract, the government [may waive] any claim for prior material breach." *Barron*, 366 F.3d at 1383; see also *Westfed Holdings, Inc.* v. *United States*, 407 F.3d 1352, 1360 (Fed. Cir. 2005) ("A party to a contract may waive the breach of an agreement by the continued acceptance of performance by the breaching party without reservation of rights."); *cf. Old Stone Corp.* v. *United States*, 450 F.3d 1360, 1371 n.6 (Fed. Cir. 2006) (discussing differences between doctrines of waiver and election). We have also stated in this context that "[w]aiver is an affirmative defense, as to which the breaching party bears the burden of proof." *Westfed*, 407 F.3d at 1360. Here, the banks bear the burden of proving that the government waived its prior material breach defense.

The plaintiffs have not asserted that they received an express statement from the government waiving its prior material breach defense. The question thus becomes whether the government impliedly waived LISB's breach. In *Westfed*, another *Winstar*-related case, we stated that "[i]mplied waiver may be inferred by conduct or actions that mislead the breaching party into reasonably believing that the rights to a claim arising from the breach was waived." 407 F.3d at 1361.

Because the Assistance Agreement at issue in *Westfed* included a provision providing a non-waiver clause stating that "[n]o forbearance, failure, or delay by any party in exercising or partially exercising ... right [given by the Agreement], power, or remedy shall operate as a waiver thereof or preclude its further exercise," we held that "a failure to object

does not amount to evidence of waiver." 407 F.3d at 1361 (modifications in original). Similarly, the Assistance Agreement in this case contains a non-waiver provision stating that "[a]ny forbearance or failure or delay by any party in exercising or partially exercising any right, power, or remedy, shall not preclude its further exercise." Assistance Agreement § 15. Therefore, the plaintiffs' fleeting reference of the government's delay, see Appellee Br. 3, does not provide evidence of the government's waiver of its prior material breach defense.[5]

Even without the non-waiver provision, we disagree with the finding of the Court of Federal Claims that "the Government continued to accept LISB's performance under the contract" after discovery of Conway's fraudulent scheme. The Court of Federal Claims did not substantiate its finding, and we can find no evidence of continued government acceptance of LISB's performance in the briefs to the Court of Federal Claims. The record indicates that all of the government's obligations under the Assistance Agreement were completed before the disclosure of the fraud. See U.S. Summ. J. Mot. 19-20, Apr. 17, 2001. The plaintiffs' argument that the government's refusal to take the thrifts back amounts to continued performance, see Pls.' Summ. J. Opp'n 53-54, May 3, 2001, conflates a contractor's claim for recission with a contractor's assertion that the government waived a prior material breach affirmative defense. And the plaintiffs' citations to the record do not support their assertion that the

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[5] We note as well that the plaintiffs do not appear to dispute the government's summary of this case's procedural history, which shows that the government filed its affirmative defenses and counterclaims before the time negotiated by the parties.

government continued to accept performance under the Assistance Agreement after discovery of the fraud. See Pls.' Summ. J. Supplemental 21 n. 12, Jun. 18, 2001 (citing government minutes and a government report from 1990); Appellee Br. 42 (stating that plaintiffs informed the government of Conway's law firm compensation arrangement, at the earliest, in September 1992).

Therefore, the plaintiffs have not shown that the government waived its prior material breach defense, and LISB's false certification constitutes an uncured material failure of performance that provides an independent basis for precluding the plaintiffs' claim for damages.

IV.

The plaintiffs argue in their combined petition for rehearing and rehearing en banc that holding in favor of the government in this case is "strikingly inequitable." In an analogous case holding a contract unenforceable against the government because the government contracting agent violated a conflict of interest statute, however, the Supreme Court stated:

> The Court of Claims was of the opinion that it would be overly harsh not to enforce this contract, since the sponsors could not have controlled Wenzell's activities and were guilty of no wrongdoing. However, we think that the court emphasized the wrong considerations. Although nonenforcement frequently has the effect of punishing one who has broken the law, its primary purpose is to guarantee the integrity of the federal contracting process and to protect the public from the corruption which might lie

> undetectable beneath the surface of a contract conceived in a tainted transaction.

Miss. Valley, 364 U.S. at 564-65; see also *Godley*, 5 F.3d at 1475 (citing *Miss. Valley* in stating that "general rule [of a government contract tainted by fraud or wrong-doing is void ab initio] protects the integrity of the federal contracting process and safeguards the public from undetectable threats to the public fisc"). Moreover, contract law provides for other theories of recovery. See, *e.g.*, *Miss. Valley*, 364 U.S. at 566 n. 22 (discussing quantum valebat recovery). Here, the plaintiffs assert that they seek "only contract damages." Appellee Br. 3. The plaintiffs' argument based on the equities is thus unpersuasive.

V.

For the reasons discussed above, we reverse the judgment of the Court of Federal Claims. Since we hold that the contract is void *ab initio*, and that the doctrine of prior material breach provides the government with a legal excuse for its nonperformance, we do not reach the issue of federal common law fraud making the contract voidable or the issues of damages.

REVERSED

Each party shall bear its own costs for this appeal.

APPENDIX B
[Initial Opinion of the United States Court Of Appeals for the Federal Circuit (Feb. 1, 2007)]

United States Court of Appeals, Federal Circuit.

The LONG ISLAND SAVINGS BANK, FSB, and the Long Island Savings Bank of Centereach FSB, Plaintiffs-Appellees,

v.

UNITED STATES, Defendant-Appellant.

No. 2006-5029.

Feb. 1, 2007.

Before MAYER, GAJARSA, and LINN, Circuit Judges.

GAJARSA, Circuit Judge.

In this *Winstar*-related case, the United States appeals a decision of the United States Court of Federal Claims granting a motion for summary judgment by the Long Island Savings Bank, FSB ("LISB") and the Long Island Savings Bank of Centereach FSB ("Centereach") on the government's counterclaim and affirmative defenses. *Long Island Sav. Bank, FSB* v. *United States* (*LISB Summ. J.*), 54 Fed. Cl. 607 (2002). The United States also appeals the decision of the Court of Federal Claims after trial awarding breach of contract damages to LISB and Centereach in the amount of $435,755,000. *Long Island Sav. Bank, FSB* v. *United States* (*LISB Trial*), 67 Fed. Cl. 616 (2005). Because we hold the claims against the government to be forfeited under 28 U.S.C. § 2514, we reverse.

I. BACKGROUND

This case is another of the many *Winstar*-cases arising from the savings and loan crisis of the 1980s. See generally *United States* v. *Winstar Corp.*, 518 U.S. 839 (1996). The facts and procedural history pertinent to this appeal follow.

A. The Parties and the Contract

In April 1982, the Federal Savings and Loan Insurance Corporation ("FSLIC") created Suffolk County Federal Savings and Loan Association ("Suffolk County") by merging two thrifts on Long Island that were incurring significant operating losses. *LISB Trial*, 67 Fed. Cl. at 619. In October 1982, FSLIC undertook a national solicitation for potential acquirers of Suffolk County because its financial condition continued to decline. *Id.* at 620. FSLIC determined that of the six bids received, the bid from LISB, a conservatively run and healthy thrift bank with branches in New York state, was the most favorable. *Id.* at 621. Negotiations began, and the parties executed a final Assistance Agreement on August 17, 1983. *Id.*

Under the Assistance Agreement, Suffolk County converted "from a federal mutual savings and loan association into a federal stock savings bank" and changed its name to Centereach, LISB acquired Centereach as a wholly owned subsidiary, and the government made a direct cash contribution of $75 million to Centereach's net worth. (Assistance Agreement at 1; *id.* § 3.) In addition, the government agreed that LISB and Centereach could use "the accounting principles in effect for mergers and acquisitions prior to the issuance of FASB # 72" to account for the acquisition. (*Id.* § 10.) Those

accounting principles enabled Centereach to account for approximately $625.4 million of goodwill to be amortized over forty years by the straight-line method. *LISB Trial*, 67 Fed. Cl. at 622. See generally *Winstar*, 518 U.S. at 853-56 (describing goodwill accounting allowed by FSLIC and advantages to acquiring institutions).

The Assistance Agreement conditioned FSLIC's obligations on, inter alia, FSLIC's "receipt of a certificate, dated as of the Purchase Date, signed by the Chairman of the Board of LISB, stating that" the "representations and warranties of LISB set forth in § 11(b) are true and substantially correct as of the Purchase Date."(Assistance Agreement § 2(c)(7).) Of pertinence here, LISB represented and warranted in section 11(b)(5) (emphasis added) the following:

> Compliance With Law. Except as disclosed in Exhibit G, *LISB is not in violation of any applicable statutes, regulations* or orders of, or any restrictions imposed by, the United States of America or any state, municipality or other political subdivision or any agency of the foregoing public units, regarding the conduct of its business and the ownership of its properties, including without limitation, all applicable statutes, regulations, orders and restrictions relating to savings and loan associations, equal employment opportunities, employment retirement income security, and environmental standards and controls where such violation would materially and adversely affect LISB's business, operations or condition, financial or otherwise.

LISB also represented and warranted in section 11(b)(9) (emphasis added):

> *Material Facts*. This Agreement and *all information furnished by LISB in connection with this Agreement or the Master Agreement do not contain any untrue statement of a material fact or omit to state a material fact necessary to be stated in order to make the statements contained therein not misleading*; and there is no fact which materially adversely affects or in the affect the business operation, affairs or condition, financial or otherwise, of LISB or any of its properties or assets which has not been set forth in this Agreement, the Master Agreement or the other documents furnished under either Agreement.

It is undisputed that LISB's Chairman certified to the government that the "representations and warranties of LISB set forth in § 11(b) are true and substantially correct" as required by § 2(c)(7) of the Assistance Agreement.

Section 16 specified that "[t]his Agreement and the rights and obligations under it shall be governed by the law of the State of New York to the extent that Federal law does not control."

B. Conway and his Law Firm Compensation

LISB and Centereach entered into the Assistance Agreement through their Chairman of the Board of Trustees and CEO James J. Conway, Jr. (Assistance Agreement at 31.) During his tenure at LISB and Centereach, Conway also received compensation from the law firm Conway & Ryan. The banks agree that Conway & Ryan was their "primary outside

counsel" that "performed mortgage closing services and occasionally represented [LISB] in foreclosure proceedings" and that a "substantial portion" of the law firm's revenues were from the banks' mortgage closing services. The parties' summary judgment submissions show that the law firm, starting in 1980 and ending with the firm's dissolution in 1992, derived at least 70% of its revenues from LISB.

Conway, an attorney admitted to the New York state bar, had worked for the law firm since 1953. Conway became a member of LISB's Board of Trustees in 1966 and the Chairman in 1976. In 1980, Conway received two legal opinions, one provided unsolicited by a partner at the law firm and one solicited by Conway from an outside attorney, stating that New York law prohibited him from receiving compensation from the law firm for legal services relating to any of the banks' loans.

In January 1982, the Board elected Conway to be LISB's CEO. After becoming CEO of LISB, Conway stopped practicing law and engaging in other professional services for the law firm. However, Conway continued to receive compensation from the law firm, and the banks agree that "Conway's compensation included revenues received by [the law firm] for performing" the "banks' mortgage closing services." From September 1975, when Conway & Ryan was incorporated as a New York professional corporation, to December 1984, Conway owned 65% of the law firm. Accordingly, Conway received at least 60% of the law firm's income for the fiscal years ending in August 1981, 1982, and 1983.

In December 1984, Conway reduced his ownership interest to 9% by, in part, transferring 51% of the law firm to his daughter. Around that

time, Conway had become aware of a thrift regulation restricting his ownership interest in the law firm to less than 10%. Conway retained his 9% ownership interest until December 1989. Conway, his daughter, and his daughter-in-law collectively, however, continued to own at least 60% of the law firm. Accordingly, while Conway received between 9% and 40% of the law firm's annual income after 1984, Conway, his daughter, and his daughter-in-law collectively received at least 60% annually, except for the fiscal year ending in August 1985 when they received 51%.

Between 1980 and 1989, Conway personally received at least $3.5 million from the law firm. Collectively, Conway, his daughter, and his daughter-in-law received at least $10.9 million from the law firm during the same time period.

While there were multiple opportunities, neither Conway nor LISB disclosed this compensation from the law firm during this time period. In December 1981, LISB "applied for conversion from a state-chartered mutual savings bank to a Federal mutual savings bank charter." To determine eligibility for conversion, the Federal Home Loan Bank Board ("FHLBB") required LISB to answer a management questionnaire, and LISB's president "stated that he [wa]s aware that approval of the application to convert w[ould] require that [LISB] adhere to various Federal and Insurance Regulations." LISB submitted, inter alia, the following responses (in italics) in February 1982.

> 6. List each enterprise doing business with the institution in which any of the institution's personnel have a direct or indirect interest. If such enterprise has had

any business transactions with the institution since the last examination, indicate the nature of the interest and the volume and type of business involved. If the association provides space, employees, equipment, services, or expenses, explain the arrangement in full.

Officer James J. Conway, Jr. retains an interest in a law firm that presently renders service to the Bank and receives remuneration from outside income of said firm.

* * *

9. List any affiliated person of the institution who receives any commission, fee, or rebate from outside sources, or benefits, directly or indirectly, from financing or any other business placed through, by, or with the institution, if such information has not been furnished in response to questions six (6), seven (7), and eight (8). Name such persons and state the amount and purpose of, and the basis and reasons for, such disbursements, credits or other benefits.

NONE

In February 1983, July 1984, and April 1986, LISB submitted the same answers regarding Conway in response to subsequent FHLBB examinations. In December 1987, FHLBB employed a different management questionnaire, but LISB continued to respond that Conway "retains an interest in a law firm that presently renders service to the Bank and receives remuneration from outside income of said firm."

C. Enactment of FIRREA

On August 9, 1989, the Government enacted the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 ("FIRREA"), Pub. L. No. 101-73, 103 Stat. 183 (1989), which restricted Centereach's ability to count supervisory goodwill and capital credit toward compliance with its tangible capital requirement. As the Supreme Court noted in *Winstar*, 518 U.S. at 857, "[t]he impact of FIRREA's new capital requirements upon institutions that had acquired failed thrifts in exchange for supervisory goodwill was swift and severe." Many institutions fell out of compliance and were either seized by government regulators or stayed in business only after "massive private recapitalization." *Id.* at 857-58.

"With FIRREA, Centereach's capital ratio plummeted from more than 8% positive to a negative 11 %." *LISB Trial*, 67 Fed. Cl. at 623. In addition, the Federal Deposit Insurance Corporation Improvement Act of 1991 ("FDICIA"), Pub.L. No. 102-242, 105 Stat. 2236 (1991), established sanctions through regulation to institutions deemed undercapitalized. The management of LISB and Centereach thus embarked on a restructuring plan, which involved selling branches, securities, and loans, paying down other borrowings, merging LISB and Centereach, and writing off goodwill. *LISB Trial*, 67 Fed. Cl. at 625, 627-28.

Several institutions sued the government "[b]elieving that [FHLBB] and FSLIC had promised them that the supervisory goodwill created in their merger transactions could be counted toward regulatory capital requirements," and the Supreme Court subsequently held in *Winstar* that neither the

canon of unmistakeability nor the doctrine of sovereign acts prevented the government from being liable for breaching contracts by subsequently changing the relevant law. 518 U.S. at 843, 858, 860.

D. Complaint Against the Government, the Discovery of Conway's Law Firm Compensation, and the Government's Affirmative Defenses

With the enactment of FIRREA, Conway hired an outside law firm to advise the banks. See *Doe* v. *Poe*, 595 N.Y.S.2d 503, 189 A.D.2d 132 (N.Y. App. Div. 1993). In February 1990, Conway, the banks' president, the outside law firm, and another outside law firm that Conway had hired for the banks met to discuss a lawsuit by the banks against the government. The outside law firms "suggested that, in preparation for the pending Federal litigation and upcoming regulatory inspections, they conduct a 'due diligence' inquiry to determine whether the bank[s were] in compliance with all regulatory requirements." Conway and the president of the banks agreed. See *id.* at 503-04. In two meetings that year, the outside law firms discovered the law firm compensation that Conway was receiving, and in August 1990, advised Conway to retain his own counsel. See *id.* at 504. "Sometime thereafter, a special committee of the bank[s'] board of trustees was formed to investigate the relationship between [Conway], his family, and his former law firm." *Id.* Conway attempted, but failed, to enjoin the outside law firms from disclosing to the committee the information learned from the meetings based on attorney-client privilege. See *id.* at 504-05.

The banks assert that they "timely informed OTS of Conway's relationship with [his law firm] upon learning the facts and filed a criminal referral with OTS and other law enforcement agencies." In June 1992, Conway resigned from LISB and Centereach. In August 1992, LISB and Centereach filed a complaint against the government in the Court of Federal Claims alleging that the government breached its contractual obligations by enacting FIRREA.

In February 1993, OTS commenced an investigation into Conway's law firm compensation. In February 1994, OTS and Conway entered into a consent order. Based on its findings, OTS concluded that Conway "engaged in violations of federal conflict-of-interest and disclosure regulations, participated in conflicts of interest constituting an unsafe or unsound practice within the meaning of 12 C.F.R. § 571.7, and breached his fiduciary duty owed to LONG ISLAND SAVINGS." "[W]hile neither admitting or denying the OTS' findings and conclusions," Conway stipulated and consented to the order banning him from the thrift and banking industry and requiring him to pay $1.3 million in restitution to LISB.

In February 1998, Conway pled guilty to a criminal misdemeanor information charging him with violating 18 U.S.C. § 215.[1] Specifically, Conway agreed with the following facts: "[i]n his capacity as chief executive officer and Chairman of LISB, ... [Conway] influenced whether LISB continued to use

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[1] 18 U.S.C. § 215 is a criminal statute governing the receipt of commissions or gifts for procuring loans by an "officer, director, employee, agent, or attorney of a financial institution."

the law firm as its legal counsel for residential mortgage closings"; "[f]rom 1983 through 1989, while holding his executive LISB positions, [Conway] received $3,194,103.87 in compensation from the law firm"; and "[i]n or about and between September 3, 1986, and October 30, 1987, ... [Conway] knowingly, intentionally and corruptly solicit[ed], demanded, accepted and agreed to accept ... funds from the law firm paid directly to him, ... intending to be influenced and rewarded in connection with ... the assignment of the LISB residential mortgage closing work to the law firm."

This conviction led the New York Supreme Court, Appellate Division, to disbar Conway for professional misconduct in August 2000. *In re Conway*, 712 N.Y.S.2d 610, 275 A.D.2d 24 (2000). Specifically, the court found:

> The mitigating circumstances proffered by the respondent notwithstanding, the fact remains that, while chairman of the board and chief executive officer of a savings bank, he engaged in a scheme of illegal kickbacks, using his daughter and daughter-in-law as conduits to circumvent Federal law prohibiting him from receiving compensation from his former law firm, which relied on the bank for approximately 90% of its business. The payments were substantial, totalling [sic] more than three million dollars. Such misconduct, which went on for several years, can hardly be deemed aberrational.

Id. at 611.

In February 2001, the government filed its answer to the complaint in the Court of Federal

Claims, including affirmative defenses and counterclaims asserting prior material breach and a special plea in fraud.

E. Proceedings Before the Court of Federal Claims

On December 9, 2002, the Court of Federal Claims decided in favor of LISB and Centereach on the parties' cross-motions for summary judgment on the government's counterclaims and affirmative defenses. *LISB Summ. J.*, 54 Fed. Cl. 607. Specifically, the Court of Federal Claims found that there was no prior material breach by LISB, *id.* at 614, and that the government's special plea in fraud failed because the government did not establish either that LISB had knowledge of the Conway's misrepresentation or that Conway's conduct should be imputed to LISB, *id.* at 617-19.

On September 15, 2005, after a twenty-four day trial, post-trial briefing, and closing arguments, the Court of Federal Claims issued its opinion and order holding the government liable and awarding $435,755,000 in damages to LISB and Centereach. *LISB Trial*, 67 Fed. Cl. at 618.

The government appeals the granting of summary judgment regarding its affirmative defenses in favor of LISB and Centereach in *LISB Summ. J.* and the determination of damages in *LISB Trial*. The Court of Federal Claims exercised jurisdiction pursuant to the Tucker Act, 28 U.S.C. § 1491(a)(1), and entered final judgment on September 30, 2005. We have jurisdiction pursuant to 28 U.S.C. § 1295(a)(3).

II. STANDARD OF REVIEW

The Court of Federal Claims applies the same summary judgment standard as that of federal district courts: summary judgment is proper if the evidence demonstrates that "there is no genuine issue as to any material fact and that the moving party is entitled to a judgment as a matter of law." *See* Ct. Fed. Cl. R. 56(c); Fed. R. Civ. P. 56(c); see also *Celotex Corp.* v. *Catrett*, 477 U.S. 317, 322-23, (1986); *SmithKline Beecham Corp.* v. *Apotex Corp.*, 403 F.3d 1331, 1337 (Fed. Cir. 2005). Therefore, we review a grant of summary judgment by the Court of Federal Claims de novo, drawing justifiable factual inferences in favor of the party opposing the judgment. *SmithKline*, 403 F.3d at 1337; *Winstar Corp.* v. *United States*, 64 F.3d 1531, 1539 (Fed. Cir. 1995) (en banc). Once the moving party has satisfied its initial burden, the opposing party must establish a genuine issue of material fact and cannot rest on mere allegations, but must present actual evidence. *Anderson* v. *Liberty Lobby, Inc.*, 477 U.S. 242, 248 (1986). Issues of fact are genuine only "if the evidence is such that a reasonable jury could return a verdict for the nonmoving party." *Id.*

III. DISCUSSION

The Court of Federal Claims held on summary judgment that the government's special plea in fraud under 28 U.S.C. § 2514 did not mandate that the claims of LISB and Centereach be forfeited. *LISB Summ. J.*, 54 Fed. Cl. at 614-20. Section 2514 provides that:

> A claim against the United States shall be forfeited to the United States by any person who corruptly practices or attempts to practice any fraud against the United States

> in the proof, statement, establishment, or allowance thereof.
>
> In such cases the United States Court of Federal Claims shall specifically find such fraud or attempt and render judgment of forfeiture.

Where a plaintiff commits fraud "in regard to the very contract upon which the suit is brought, this court does not have the right to divide the contract under which he practiced fraud against the Government" and "all of his claims under that contract will be forfeited pursuant to 28 U.S.C. § 2514." *Little* v. *United States*, 138 Ct. Cl. 773, 152 F. Supp. 84 (1957).

A. Burden of proof

We have "explained that '[t]o prevail under [§ 2514], the government is required to establish by clear and convincing evidence that the contractor knew that its submitted claims were false, and that it intended to defraud the government by submitting those claims.'" *Glendale Fed. Bank, FSB* v. *United States*, 239 F.3d 1374, 1379 (Fed. Cir. 2001) (quoting *Commercial Contractors, Inc.* v. *United States*, 154 F.3d 1357, 1362 (Fed. Cir. 1998)); *cf. Young-Montenay, Inc.* v. *United States*, 15 F.3d 1040, 1042 (Fed. Cir. 1994) ("Under 28 U.S.C. § 2514, the government bears the burden of proving that the claimant (1) knew the claim was false and (2) intended to deceive the government by submitting it.").

The parties do not dispute that the government must prove the *Glendale* elements of (1) knowledge of submission of false claims and (2) intent to defraud. There appears to be some uncertainty,

however, in the Court of Federal Claims as to whether the government must also prove the common law elements of fraud. Specifically, the Court of Federal Claims observed in this case that § 2514 does not define the applicable elements of fraud and noted that it has used the Glendale elements in some cases and the common law fraud elements in other cases. *LISB Summ. J.*, 54 Fed. Cl. at 615. Use of common law fraud elements adds to the government's burden the elements of (3) justifiable reliance and (4) injury. See *id.* Neither the Supreme Court nor this court has addressed whether the government must also prove these additional common law elements under § 2514.

Requiring proof of justifiable reliance and injury under § 2514 appears to originate in *Colorado State Bank of Walsh* v. *United States*, 18 Cl. Ct. 611 (1989), a decision of the Claims Court, which is now the Court of Federal Claims.[2] See *LISB Summ. J.*, 54 Fed. Cl. at 615; *First Fed. Bank of Hegewisch* v. *United States*, 52 Fed. Cl. 774, 789-90 (2002); *Landmark Land Co., Inc.* v. *United States*, 46 Fed. Cl. 261, 274 (2000); *BMY-Combat Sys. Div. of Harsco Corp.* v. *United States*, 38 Fed. Cl. 109, 128 (1997). The *Colorado State Bank* court found that we "approached the issue of fraud in forfeiture of claims cases on a case-by-case basis, and applied the common law elements of fraud." 18 Cl. Ct. at 629. While citing no cases requiring justifiable reliance, the *Colorado State Bank* court cited *Crovo* v. *United*

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[2] As noted in *Winstar*, 64 F.3d at 1534 n. 2, "[t]he Federal Courts Administration Act of 1992, Pub. L. No. 102-572, § 902(a), 106 Stat. 4506, 4516, changed the name of the former United States Claims Court to the 'United States Court of Federal Claims.'"

States, 100 Ct. Cl. 368 (1943), for the proposition that there could be no § 2514 forfeiture without injury. 18 Cl. Ct. at 629 n. 17.

In *Crovo*, however, our predecessor court did not hold that § 2514 required proof of government injury. Rather, *Crovo* stated that "[a]lthough it is not necessary to show a pecuniary loss to defeat a fraudulent claim, it is necessary to do so where a claim has been paid and an action is brought to recover the amount paid." 100 Ct. Cl. at 368. *Crovo* also noted that the latter action would not be brought under § 2514.

> Nor does section [2514] provide for an action to recover money paid on a false claim. The only remedy given the Government by this section is the forfeiture of the claim, and in consequence the relief of the Government from liability therefor. After payment there is no claim to be forfeited. It may be the Congress might have provided for a suit against a claimant who had been paid on a false claim, if it had thought of it, but it has not done so.

100 Ct. Cl. at 368. Therefore, *Colorado State Bank* and its Court of Federal Claims progeny are based on a legal misinterpretation of our precedent, which states explicitly that "it is not necessary to show a pecuniary loss to defeat a fraudulent claim" under § 2514. 100 Ct. Cl. at 368.

There is no language in the plain meaning of the statute that would impose requirements of reliance and injury, especially when used as an affirmative defense rather than as a cause of action, and we have found nothing in the legislative history of the

original Court of Claims Act that indicates otherwise. Indeed, Congress's objective to "guard against ... frauds in the claims in the court" and to impose forfeiture "as a preventative and a penalty" in § 2514 would seem to point against requiring reliance and injury. *O'Brien Gear & Mach. Co.* v. *United States*, 219 Ct. Cl. 187, 591 F.2d 666, 678 (1979) (adopting opinion of trial judge). However, we need not go any further. The parties have not asked us to extend *Glendale* to require justifiable reliance and injury, and we perceive no reason to do so here.

Accordingly, for the government to prevail in its special plea in fraud in this case, it must prove "by clear and convincing evidence that the contractor knew that its submitted claims were false, and that it intended to defraud the government by submitting those claims." *Glendale*, 239 F.3d at 1379. The government asserts that it has met this burden because LISB certified that the representations and warranties of the Assistance Agreement were true and substantially correct.

B. Submitted claims

Section 2(c)(7) of the Assistance Agreement conditioned the government's obligations on the receipt of a certificate "signed by the Chairman of the Board of LISB stating," inter alia, that the "representations and warranties of LISB set forth in § 11(b) are true and substantially correct as of the Purchase Date." It is undisputed that Conway as Chairman and CEO of LISB had the authority to submit the certification and did so. LISB Summ. J., 54 Fed. Cl. at 615-16. In addition, there is no dispute that Conway's conduct in submitting the

certification should be imputed to LISB.[3] Therefore, the certification required by section 2(c)(7) constituted a submitted claim to the government.

C. Falsity

By submitting the certification, LISB certified that the "representations and warranties of LISB set forth in § 11(b) [we]re true and substantially correct as of the Purchase date." The falsity of the certification thus depends on the representation and warranty provisions of the contract.

LISB represented and warranted in section 11(b)(5) of the Assistance Agreement that it was "not in violation of any applicable statutes, regulations or orders." The government argued on appeal that the contract thus required LISB to comply with 12 C.F.R. § 563.17(a) (1984), which provided that LISB and Centereach "shall maintain safe and sound management." In addition, the regulations charged FHLBB with "the enforcement of laws, regulations, or conditions against ... the officers or directors," 12 C.F.R. § 500.3 (1984), and FHLBB required that officers refrain from breaching fiduciary duties involving personal profit, see 12 C.F.R. § 563.39 (1984) ("Termination for cause shall include termination because of ... breach of fiduciary duty involving personal profit.").

In this case, the Court of Federal Claims found that "Conway and his firm's impropriety under

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[3] Neither LISB nor Centereach have raised any issues regarding the Assistance Agreement requiring the certification of the Chairman of LISB but not of Centereach. Indeed, for purposes of the special plea in fraud, all of the parties have treated LISB and Centereach as the same in this appeal. Therefore, we do so as well.

banking laws is evident." *LISB Summ. J.*, 54 Fed. Cl. at 614. Similarly, "based on its findings from the Investigation, the OTS" concluded that Conway "breached his fiduciary duty owed to" LISB. As a result, Conway consented to an order that banned him from the thrift and banking industry and that required him to pay $1.3 million in restitution and reimbursement to LISB. The banks concede that Conway's compensation from the law firms during the time he was Chairman and CEO of LISB and Centereach, between at least 1982 and 1989, "included revenues received by [the law firm] for performing" the "banks' mortgage closing services." Moreover, by pleading guilty to violating 18 U.S.C. § 215, Conway admitted that he committed a crime by corruptly accepting $3,194,103.87 in compensation from the law firm intending to be influenced and rewarded for "the assignment of the LISB residential mortgage closing work to the law firm." Therefore, we agree that Conway breached his fiduciary duties to LISB and Centereach and profited personally from that breach.

Nonetheless, the Court of Federal Claims found that LISB was not operating in an unsafe and unsound manner under 12 C.F.R. § 563.17. The Court of Federal Claims reasoned that "had Conway not accepted compensation related to mortgage closing services of LISB's borrowers, but the relationship between LISB and the firm was otherwise the same, no impropriety would exist." *LISB Summ. J.*, 54 Fed. Cl. at 614. By focusing solely on the relationship between LISB and the law firm, the Court of Federal Claims improperly ignored the relationship between Conway and both LISB and Centereach. Specifically, the Chairman of the Board and CEO of LISB and Centereach breached his

fiduciary duties for personal profit. This is not safe and sound management. Even if it were unclear whether Conway's conduct precluded a finding of safe and sound management, LISB represented and warranted in section 11(b)(9) of the Assistance Agreement that it would not "omit to state a material fact necessary to be stated in order to make the statements contained therein not misleading." At a minimum, Conway's conduct was a material fact necessary to make LISB's section 11(b)(5) representation and warranty of compliance with law, including safe and sound management, not misleading.

Accordingly, LISB's certification to the government regarding the "true and substantially correct" nature of the representations and warranties made in the Assistance Agreement was false.

D. Knowledge

The Court of Federal Claims found that "[a]lthough LISB knew Conway was being compensated by his firm, this Court cannot conclude that [others at] LISB knew that the arrangement was improper, and, therefore, a misrepresentation." *LISB Summ. J.*, 54 Fed. Cl. at 616-17. We see no error in this factual conclusion. The critical inquiry thus becomes whether Conway's knowledge of the certification's falsity is imputed to LISB.

1. Law of knowledge imputation

Whether federal common law or state law applies to imputation of knowledge under 28 U.S.C. § 2514 is a question of first impression. In *O'Melveny & Myers* v. *FDIC*, 512 U.S. 79 (1994), the Supreme Court held that state law governs issues of knowledge

imputation when the FDIC sues as receiver of a corporation under causes of action created by state law. The Court reasoned (1) that FIRREA, which empowered the FDIC as receiver, did not preempt state imputation law and (2) that judicial creation of a special federal rule was not justified because there was no significant conflict between a federal policy or interest and the use of state law. See *id.* at 85-89; *cf. Atherton* v. *FDIC*, 519 U.S. 213 (1997) (holding that state law, not federal common law, governed legal standard of care owed to federally chartered, federally insured institutions). In this case, however, federal law may govern the breach of contract action. See *Franconia Assocs.* v. *United States*, 536 U.S. 129, 141-43 (2002) (applying principles of general contract law by relying in part on Restatement (Second) of Contracts (1979) to determine whether contract claim against federal government was within Tucker Act statute of limitations); *cf. Wagner Iron Works* v. *United States*, 146 Ct. Cl. 334, 174 F.Supp. 956, 958 (1959). In addition, there may be a significant federal interest in specifying the knowledge imputation rules applicable to 28 U.S.C. § 2514 because § 2514 "is one of the conditions on which the Government gives its consent to be sued and waives its otherwise sovereign immunity." *Kamen Soap Prods. Co.* v. *United States*, 129 Ct. Cl. 619, 620 (1954). Indeed:

> The source of present-day section 2514 of Title 28 is the Court of Claims Act of March 3, 1863, ch. 92, 12 Stat. 765. This statute transformed the Court of Claims from a body merely advisory to Congress into a court with power to entertain claims, subject to a statute of limitations, hear the Government's

> counterclaims and enter judgments to be paid out of a general appropriation.

O'Brien, 591 F.2d at 678. As such, the law governing the elements of § 2514 influences the scope of the federal government's waiver of sovereign immunity.

Under the general common law of agency, "[e]xcept where the agent is acting adversely to the principal..., the principal is affected by the knowledge which an agent has a duty to disclose to the principal ... to the same extent as if the principal had the information." Restatement (Second) of Agency § 275 (1958); *cf. Comty. For Creative Non-Violence* v. *Reid*, 490 U.S. 730, 751-52 (1989) (relying on Restatement (Second) of Agency to determine whether hired party is employee under general common law of agency for Copyright Act purposes); *Franconia*, 536 U.S. at 141-43 (applying principles of general contract law by relying in part on Restatement (Second) of Contracts (1979) on contract claim against federal government). The Restatement (Second) of Agency § 282 (1958) specifies when an agent is acting adversely to the principal:

> (1) A principal is not affected by the knowledge of an agent in a transaction in which the agent secretly is acting adversely to the principal and entirely for his own or another's purposes, except as stated in Subsection (2).
>
> (2) The principal is affected by the knowledge of an agent who acts adversely to the principal:
>
> > (a) if the failure of the agent to act upon or to reveal the information results in a violation of a contractual or relational duty

> of the principal to a person harmed thereby;
>
> (b) if the agent enters into negotiations within the scope of his powers and the person with whom he deals reasonably believes him to be authorized to conduct the transaction; or
>
> (c) if, before he has changed his position, the principal knowingly retains a benefit through the act of the agent which otherwise he would not have received.

In addition, the "mere fact that the agent's primary interests are not coincident with those of the principal does not prevent the latter from being affected by the knowledge of the agent if the agent is acting for the principal's interests." Restatement (Second) of Agency § 282 cmt. c.

New York state law has similar standards for the general rule of imputation and the adverse interest exception:

> In general, knowledge acquired by an agent acting within the scope of his or her agency is imputed to the principal and the latter is bound by that knowledge even if the information is never actually communicated. An exception to this rule occurs when the agent has abandoned his or her principal's interests and is acting entirely for his or her own or another's purposes.

Christopher S. v. *Douglaston Club*, 713 N.Y.S.2d 542, 275 A.D.2d 768 (N.Y. App. Div. 2000) (citing *Center* v. *Hampton Affiliates, Inc.*, 66 N.Y.2d 782, 488 N.E.2d 828, 829-30 (N.Y. 1985)). The adverse

interest exception "cannot be invoked merely because he has a conflict of interest or because he is not acting primarily for his principal." *Center*, 488 N.E.2d at 830 (citations omitted). However, the general principles of agency and New York state law may diverge on the exceptions enumerated in Restatement (Second) of Agency § 282(2) to the adverse interest exception. Specifically, we have found New York precedent only for § 282(2)(c).

While there may be differences between federal common law and state law, it seems to us imprudent to resolve the question of which law applies to knowledge imputation under 28 U.S.C. § 2514 without briefing. Moreover, we can resolve this case based on where federal and state laws are the same. Namely, the general rule of imputation, the adverse interest exception, and the Restatement (Second) of Agency § 282(2)(c) exception to the adverse interest exception.

Under the general rule of imputation, it is undisputed that Conway was an agent of the banks and had knowledge of his compensation scheme. Therefore, the first step indicates that Conway's knowledge should generally be imputed to the banks, and we proceed to examine whether the adverse interest exception or its exception applies.

2. Adverse interest exception

The Court of Federal Claims found that Conway "ha[d] abandoned his principal's interest and [wa]s acting to defraud his principal, entirely for his own or another's purpose" because "had the knowledge that the Government seeks to impute to LISB actually been disclosed to LISB, the success of Conway's scheme would have been impaired." *LISB*

Summ. J., 54 Fed. Cl. at 619. We do not agree with this analysis or its conclusions.

It is true that Conway pursued his own interests in his improper compensation arrangement with his law firm. However, this conflict of interest does not mean that Conway abandoned the banks' interest entirely. For example, by causing LISB to utilize the law firm exclusively, Conway continued to serve LISB's interests in part by ensuring that its representation requirements with mortgage loan closings were met. In addition, by signing the false certification under the Assistance Agreement, Conway enabled LISB to acquire Centereach under previously negotiated terms. In hindsight, LISB's interests probably would have been better served had Conway not perpetrated his improper compensation arrangement, but the record fails to support the assertion that Conway entirely abandoned LISB's interests for his own.

Accordingly, the Court of Federal Claims erred in finding that the adverse interest exception should apply to preclude imputation to LISB. See Restatement (Second) of Agency § 282 rptr.'s note ("Whether the agent's interests are sufficiently adverse to bring the rule into operation is a question to be decided by the triers of fact.").

3. Restatement (Second) of Agency § 282(2)(c) exception

Even if the adverse interest exception were to apply, Conway's knowledge would be imputed to LISB if "the principal knowingly retains a benefit through the act of the agent which otherwise he would not have received." Restatement (Second) of Agency § 282(2)(c); see also *In re Maxwell*

Newspapers, Inc., 164 B.R. 858, 867 (Bankr. S.D.N.Y. 1994) ("As the Tenth Circuit so aptly put it, 'If the principal disclaims the agent's acts as unauthorized, he has no grounds to retain the fruits thereof; on the other hand, if he retains the fruits of the agent's acts, after knowledge of the facts, he must in fairness be charged with the agent's knowledge.'" (citations omitted)); *Zanoni* v. *855 Holding Co., Inc.*, 465 N.Y.S.2d 763, 764-65, 96 A.D.2d 860 (N.Y. App. Div. 1983) ("An agent's fraud can be imputed to the corporation, and a corporation will be deemed to have ratified the agent's acts, where, as here, it retains the benefit of those acts for corporate purposes." (citations omitted)).

In this case, the certification signed by Conway fulfilled an explicit provision of the Assistance Agreement with the government and enabled LISB to reap the contractual benefits. Indeed, the breach of contract suit at issue is founded on that Assistance Agreement, and thus, LISB and Centereach have knowingly retained the benefits reaped by Conway's certification even after discovering its fraudulent nature. In effect, the banks have ratified Conway's fraudulent certification, and we would impute Conway's knowledge of the certification's falsity even if the adverse interest exception were to apply.

Accordingly, LISB and Centereach knew by law that the certification to the government was false.

E. Intent to defraud

For the same reasons that allow Conway's knowledge to be imputed to LISB and Centereach, we can impute an intent to defraud from Conway. Therefore, the question becomes whether Conway had an intent to defraud the government in

submitting the false certification under the Assistance Agreement.

Where there is no direct evidence of intent to defraud or to deceive, we find our case law in analogous contexts instructive. "Intent need not be proven by direct evidence; it is most often proven by a showing of acts, the natural consequences of which are presumably intended by the actor. Generally, intent must be inferred from the facts and circumstances surrounding the applicant's conduct." *Molins PLC* v. *Textron, Inc.*, 48 F.3d 1172, 1180-81 (Fed. Cir. 1995) (discussing affirmative patent defense of inequitable conduct) (citations omitted); see also *In re Watman*, 301 F.3d 3, 8 (1st Cir. 2002) (noting that few cases turn on direct evidence of intent and thus, looking instead to circumstances and objective indicia in bankruptcy context).

> The fact of misrepresentation coupled with proof that the party making it had knowledge of its falsity is enough to warrant drawing the inference that there was a fraudulent intent. Thus, circumstantial evidence may permit an inference of intent. In determining whether an inference of intent can be drawn from circumstantial evidence, it is proper to consider the degree of materiality of the information.

Lipman v. *Dickinson*, 174 F.3d 1363, 1370 (Fed. Cir. 1999) (discussing duty of candor patent applicants owe to PTO) (citations omitted). But see *Nobelpharma AB* v. *Implant Innovations, Inc.*, 141 F.3d 1059, 1069-71 (Fed. Cir. 1998).

LISB and Centereach assert on appeal that the government failed to offer any proof that Conway

had an intent to defraud when failing to acknowledge his law firm compensation in the Assistance Agreement certification. This is incorrect for the record demonstrates that Conway had knowledge of the certification's falsity. First, as discussed, Conway certified under the Assistance Agreement that there were no omissions of material fact regarding LISB's compliance with the law, including the regulation requiring "safe and sound management," that would mislead the government. Second, Conway received two legal opinions before submitting the Assistance Agreement certification stating that he was legally prohibited from receiving compensation from the law firm for legal services relating to any of the banks' loans. Third, the banks concede that Conway's compensation from the law firms during the time he was Chairman and CEO of LISB and Centereach, between at least 1982 and 1989, "included revenues received by [the law firm] for performing" the "banks' mortgage closing services." Therefore, there was no error in the finding of the Court of Federal Claims that Conway entered into the Assistance Agreement "knowing his conflicting dual relationship with his firm and LISB prohibited him from entering into the Assistance Agreement and from receiving compensation from his firm." *LISB Summ. J.*, 54 Fed. Cl. at 615-16. This record supports an inference of intent.

Moreover, the active breaching of fiduciary duties by the Chairman of the Board and the CEO constitutes material information when the government undertakes a national solicitation for potential acquirers of a declining financial institution, contributes $75 million of cash to the declining institution's net worth, and conditions performance on a representation and warranty of

compliance with the law, including regulations requiring "safe and sound management." Indeed, the government's supervisory agent responsible for recommending whether LISB's acquisition of Centereach should be approved in 1983 declared that "[h]ad Mr. Conway correctly and accurately revealed the nature and substance of the kickback scheme ... I would have recommended that we discontinue discussions and negotiations with [LISB]." While these assertions may be true, we hold that the government need not prove that it would have declined the contract had Conway disclosed the information. Rather, the circumstances of this case indicate that the government would have considered it important in deciding whether to consummate the contract. *Cf. Liquid Dynamics Corp.* v. *Vaughan Co., Inc.*, 449 F.3d 1209, 1227 (Fed. Cir. 2006) (stating in inequitable conduct patent context: "Our inquiry into materiality is an objective one. 'Materiality is not limited to prior art but embraces any information that a reasonable examiner would be substantially likely to consider important in deciding whether to allow an application to issue as a patent.'" (citation omitted)).

Our conclusion that Conway had an intent to defraud is further supported by the facts surrounding the Assistance Agreement. First, neither Conway nor LISB accurately disclosed the compensation from his law firm when prompted by the government in February 1982, February 1983, July 1984, April 1986, or December 1987. In each instance, LISB responded that Conway "retains an interest in a law firm that presently renders service to the Bank and receives remuneration from outside income of said firm." This was false because, as the banks concede, Conway's compensation from the law

firm "included revenues received by [the law firm] for performing" the "banks' mortgage closing services." In pleading guilty, Conway also admitted that: "[i]n his capacity as chief executive officer and Chairman of LISB, ... [Conway] influenced whether LISB continued to use the law firm as its legal counsel for residential mortgage closings"; "[f]rom 1983 through 1989, while holding his executive LISB positions, [Conway] received $3,194,103.87 in compensation from the law firm"; and "[i]n or about and between September 3, 1986, and October 30, 1987, ... [Conway] knowingly, intentionally and corruptly solicit[ed], demanded, accepted and agreed to accept ... funds from the law firm paid directly to him, ... intending to be influenced and rewarded in connection with ... the assignment of the LISB residential mortgage closing work to the law firm." LISB and Centereach attempt to minimize the significance of Conway's guilty plea, citing to his trial testimony in this case where he explained that he pled to protect his children. However, "a party cannot simply contradict an earlier sworn statement," and there is no credible evidence here supporting the contradiction. *Cf. Gemmy Indus. Corp.* v. *Chrisha Creations Ltd.*, 452 F.3d 1353, 1359 (Fed. Cir. 2006) (finding summary judgment grant improper where credible evidence supported contradiction).

Second, when the banks' outside counsel, ironically hired by Conway himself, discovered Conway's law firm compensation, Conway attempted but failed to enjoin the outside counsel from disclosing the information to other bank personnel. *See Doe* v. *Poe*, 595 N.Y.S.2d at 504-05.

Therefore, under the circumstances of this case, the only justifiable inference is that Conway had an intent to defraud, and LISB and Centereach have not presented evidence such that a reasonable jury could return a verdict in their favor. *See* Anderson, 477 U.S. at 248 (stating that issues of fact are genuine for summary judgment purposes only "if the evidence is such that a reasonable jury could return a verdict for the nonmoving party"). Accordingly, the government has proven its special plea in fraud by clear and convincing evidence. Conway knew that the certification he submitted under the Assistance Agreement was false, Conway intended to defraud the government by submitting the certification, and Conway's knowledge and intent should be imputed to LISB and Centereach.

IV. CONCLUSION

For the reasons discussed above, we reverse judgment of the Court of Federal Claims. Since we hold all asserted contract claims against the government under the Assistance Agreement to be forfeited under 28 U.S.C. § 2514, we do not reach questions of damages.

REVERSED

No costs.

APPENDIX C
[Opinion of the United States Court of Federal Claims (Sept. 15, 2005)]

United States Court of Federal Claims.

THE LONG ISLAND SAVINGS BANK, FSB, and The Long Island Savings Bank of Centereach FSB, Plaintiffs,

v.

The UNITED STATES, Defendant.

No. 92-517-C.

Sept. 15, 2005.

OPINION AND ORDER

LETTOW, Judge.

INTRODUCTION

Both liability and damages remain unresolved in this *Winstar*-related case.[1] Plaintiffs are federal savings banks or "thrifts" which allege that the government breached a contract entered in 1983 involving the treatment of goodwill as regulatory capital and that plaintiffs suffered expectancy and reliance damages as a result of the breach. To adjudicate the disputed issues of fact, the court conducted a 24-day trial commencing on January 18, 2005 and ending on March 23, 2005. Post-trial briefs were filed thereafter, and a closing argument was

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[1] See *United States* v. *Winstar Corp.*, 518 U.S. 839 (1996).

held on July 7, 2005. The case is now ready for disposition.[2]

For the reasons set out below, the court finds that the government entered into a contract with plaintiffs providing for, among other things, the recognition of goodwill amounting to approximately $625.4 million in connection with the acquisition by plaintiff The Long Island Savings Bank, FSB ("Syosset") of The Long Island Savings Bank of Centereach FSB ("Centereach") from the Federal Savings and Loan Insurance Corporation ("FSLIC") with the participation of the Federal Home Loan Bank Board ("FHLBB" or "Bank Board"). The contract also provided for the use of push-down accounting regarding the acquisition, for the treatment of the goodwill as regulatory capital, and for the amortization of the goodwill over a period of forty years. The court additionally finds that this contract was breached by the government upon the enactment on August 9, 1989 of the Financial Institutions Reform, Recovery, and Enforcement Act ("FIRREA"), Pub. L. No. 101-73, 103 Stat. 183

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[2] Previously, Senior Judge Margolis granted a motion by plaintiffs for summary judgment on defendant's counterclaims and affirmative defenses. *Long Island Sav. Bank* v. *United States*, 54 Fed. Cl. 607 (2002). Subsequently, this court denied cross-motions for summary judgment on damages, except that the court held that plaintiffs as a matter of law were not entitled to pursue certain damage theories, including among other things, that they could not recover as a component of expectancy damages the cost of replacing $1.06 billion of deposits lost due to branch sales that occurred in mitigating the loss of goodwill as regulatory capital and that plaintiffs could not seek restitution as a remedy where they continued in operation. *Long Island Sav. Bank* v. *United States*, 60 Fed. Cl. 80, 96-97 (2004).

(codified in scattered sections of Title 12 of the U.S. Code, including 12 U.S.C. § 1464), and the adoption of implementing regulations on November 8, 1989, to be effective December 7, 1989, by the Office of Thrift Supervision ("OTS"), the successor of the Bank Board under FIRREA.[3] The court further finds that plaintiffs are entitled to damages caused by the breach in the amount of $435,755,000.

FACTS[4]

Syosset

Syosset was a conservatively run, "plain vanilla" bank with branches on Long Island, in Queens, Nassau, and Suffolk counties. Tr. 3913:23 to 3914:1, 3917:10-16 (Test. of James J. Conway, Jr., Syosset's chairman of the board of directors and chief executive officer); Tr. 66:11-14 (Test. of Mark Fuster, at various times Syosset's senior vice president, treasurer, and chief financial officer); Tr. 981:2-8 (Test. of William E. Viklund, Syosset's president and chief operating officer). Syosset was organized as a New York State chartered mutual savings bank in 1876 and had converted to a federal mutual savings bank in December 1982. DX606 at WOQ 632 1702 (Prospectus by Long Island Savings Bank, FSB (Feb. 14, 1994)). Early in the 1980s, Syosset was a healthy thrift that had twelve branches, roughly $950 million

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[3] FIRREA also abolished FSLIC and transferred its insurance functions to the Federal Deposit Insurance Corporation ("FDIC"). See *Winstar*, 518 U.S. at 856.

[4] This recitation of facts constitutes the court's principal findings of fact in accord with Rule 52(a) of the Rules of the Court of Federal Claims ("RCFC"). Other findings of fact and rulings on questions of mixed fact and law are set out in the analysis.

to $1 billion in assets, and a tangible net worth of approximately 8% of those assets, or $80 million. Tr. 981:9-22 (Test. of Viklund). Syosset's management realized that it would have to grow to remain competitive and to address the marketing and technological changes that were occurring in the banking industry following considerable deregulation. Tr. 982:7-16 (Test. of Viklund).

The FDIC's Creation of Suffolk Phoenix

In 1979, two other sizeable thrifts on Long Island, County Federal Savings and Loan Corporation ("County") and Suffolk County Federal Savings and Loan Association ("Old Suffolk"), began incurring significant operating losses. See PX 5 at 5-10 (Memo from Edward J. O'Connell, III, Regional Director, FHLBB, to J.J. Finn, Secretary to the Board, FHLBB (May 13, 1983)). County was almost as large as Syosset, and Old Suffolk was actually larger than Syosset. Tr. 66:5 to 67:13 (Test. of Fuster). County and Old Suffolk were merged in April 1982 under FSLIC's "Phoenix program,"[5] resulting in the creation of Suffolk County Federal

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[5] FSLIC designed the Phoenix program

> to consolidate several failing or failed thrifts into a single association that would not only achieve efficiencies and receive close regulatory oversight, but would also receive significant assistance from the federal government. This assistance included direct monetary contributions, regulatory forbearances, and authorization to use a purchase accounting system whereby assets and liabilities would be revalued at market price and the ensuing net liability would be recorded as an asset called 'supervisory goodwill' and accorded an extended amortization term.

LaSalle Talman Bank, F.S.B. v. *United States*, 317 F.3d 1363, 1367 (Fed. Cir. 2003).

Savings and Loan Association ("Suffolk Phoenix"). PX 5 at 1. In connection with this merger, Suffolk Phoenix received $62 million from FSLIC in the form of interest-bearing notes in exchange for income capital certificates ("ICCs") and net worth certificates ("NWCs"). PX 78 at LIP0017898 (Suffolk Phoenix's Consolidated Financial Statements and Schedules (Dec. 31, 1982)). Suffolk Phoenix recorded on its books approximately $742 million of supervisory goodwill to be amortized over forty years on the straight-line method. *Id.*

Syosset's Acquisition of Suffolk Phoenix

In August 1982, Syosset, acting through its legal counsel, offered to acquire Suffolk Phoenix from FSLIC. See PX 67 (Letter from Douglas P. Faucette, Muldoon & Murphy, to H. Brent Beesley, Director, FSLIC (Aug. 31, 1982)). Syosset's offer letter proposed that it acquire Suffolk Phoenix through a direct merger in exchange for a capital contribution by FSLIC in the amount of $225 million. *Id.* at 1. In addition, Syosset conditioned its offer on the Bank Board's approval of Syosset's use of "the purchase method of accounting pursuant to the method generally accepted in the savings and loan industry on August 9, 1982 ... [,] includ[ing] the straight line amortization of any goodwill created by such adjustment [of Syosset's assets] for a 40-year period." *Id.* at 2. By this language, Syosset sought to grandfather generally accepted accounting principles ("GAAP") as they existed prior to the Financial Accounting Standards Board's promulgation of Statement of Financial Accounting Standards No. 72 ("SFAS 72") in February 1983. See DX 1238 (SFAS 72); Tr. 94:22 to 97:11 (Test. of Fuster). As the Supreme Court explained in *Winstar*,

> SFAS 72 eliminated any doubt that the differential amortization periods on which acquiring thrifts relied to produce paper profits in supervisory mergers were inconsistent with GAAP. SFAS 72 also barred double counting of capital credits by requiring that financial assistance from regulatory authorities must be deducted from the cost of the acquisition before the amount of goodwill is determined.

Winstar Corp., 518 U.S. at 855 (citation omitted). Syosset's August 1982 proposal requested pre-SFAS 72 accounting treatment to set in place a permissible, favorable accounting option that would soon become obsolete. Although SFAS 72 was "applied prospectively to business combinations initiated after September 30, 1982[,] ... [r]etroactive application to a business combination initiated prior to October 1, 1982[wa]s permitted but not required." DX 1238 15.

Syosset's offer letter further proposed that "[n]otwithstanding any change in generally accepted accounting principles o[r the] interpretation thereof, ... FHLBB shall permit LISB to report for any and all regulatory purposes as well as any reports published to its customers, creditors, depositors, security holders or the public, its financial condition and operations in accordance with the results of the [purchase method] adjustments described in the preceding sentence." PX 67 at 2. In that connection, Syosset requested from FSLIC an indemnification for any lost profits caused by a subsequent governmental decision to disallow use of the purchase method of accounting. *Id.* at 2-3. FSLIC did not respond to Syosset's August 1982 offer. Tr.

94:22 to 99:18 (Test. of Fuster); Tr. 996:18 to 1000:16 (Test. of Vicklund).

Subsequent to the merger between County and Old Suffolk, the financial condition of the resulting institution continued to decline. See PX 5 at 1-4 (Memo from O'Connell to Finn (May 13, 1983)). Consequently, in October 1982, the regulators undertook a national solicitation for potential acquirers of the Suffolk Phoenix and conducted a bidders' conference in December of that year. *Id.* at 11. Syosset attended that conference and submitted a proposal in January 1983, PX 3 (Letter from John R. Hall, Muldoon, Murphy, Bray & Faucette, to Angelo A. Vigna, Supervisory Agent, FHLBB (Jan. 20, 1983)), which proposal Syosset supplemented and amended in April of the same year. PX 4 (Letter from Hall to Beesley (Apr. 5, 1983)). The offer submitted in January contained two alternative bids, one proposing assistance from FSLIC in the form of capital certificates, and the other requesting a combination of capital certificates, cash, and subsidized borrowings. See PX 3. An amended proposal by Syosset in April 1983 contained only the latter bid; in these proposals, Syosset uniformly requested accounting treatment containing elements that had been put forward in its offer of August 1982, but in somewhat modified form. See PX 4; Tr. 110:14-22 (Test. of Fuster).

Syosset's overriding goal with respect to the proposed transaction was to protect itself from Suffolk Phoenix's tangible-capital deficit. Tr. 68:25 to 69:6, Tr. 72:3-14 (Test. of Fuster); PX 57, item (2) (list of items to consider for acquisition). Syosset's secondary goal was to secure its ability to use the resulting goodwill to stay in business, but not to

grow. See Tr. 657:15 to 660:15 (Test. of Fuster); Tr. 1153:4 to 1155:18 (Test. of Viklund); Tr. 3915:10-23 (Test. of Conway); DX 1545 at 1 (Letter from James J. Nacos, the banks' executive vice president and secretary, to Stephen D. Rohrs, Assistant District Director, OTS (Jan. 31, 1991)). To achieve these goals, Syosset proposed that Suffolk Phoenix would convert to the stock form, and Syosset would acquire Suffolk Phoenix as a wholly-owned subsidiary, rather than by merger, for a purchase price of $100,000 in exchange for capital stock. PX 3 at 3-4; PX 4 at 2.[6] In addition, Syosset would maintain the subsidiary's net worth ratio at a minimum of one percent. PX 3 at 4; PX 4 at 2. Regarding the proposed accounting treatment, Syosset would be permitted to record goodwill "in accordance with the purchase method of accounting pursuant to the method generally accepted in the savings and loan industry on August 9, 1982," and "[s]uch method [would] include the straight line amortization of any goodwill created by such adjustment for a 40-year period ...." PX 3 at 4; PX 4 at 3. Syosset's bid further provided that "[n]otwithstanding any change in generally accepted accounting principles or interpretation thereof, ... the [Bank] Board shall permit Suffolk [Phoenix] and LISB to report for any and all regulatory purposes"

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[6] The change in form of the transaction from a proposed merger to a proposed purchase of all of the stock of a subsidiary reflected in Syosset's August 1982 and January 1983 proposals, respectively, was due to the Bank Board's establishment on January 17, 1983 of a new method of accounting, known as "push-down" accounting, for thrifts entering into purchase transactions. Bank Board Memorandum R-55 permitted an acquirer to record, or "push-down," goodwill onto the books of the acquired association. See PX 8 (Memorandum R-55 (Jan. 17, 1983)); Tr. 102:16 to 105:2 (Test. of Fuster).

in accordance with pre-SFAS 72 accounting treatment. PX 3 at 4; PX 4 at 3; Tr. 106:3 to 107:23 (Test. of Fuster).

Out of six bids received, FSLIC "determined that the bid of LISB [wa]s the most favorable." PX 5 at 11-12 (Memo from O'Connell to Finn (May 13, 1983)); see also PX 95 at 5-7 ("A Memo" from David W. Glenn, Director, FSLIC, to FHLBB (Aug. 9, 1983)). Thereafter, representatives of Syosset and the Bank Board engaged in detailed negotiations regarding the nature of the assistance FSLIC would provide, the accounting treatment that Syosset and its subsidiary would apply, and the period of amortization of goodwill that the transaction would generate. The negotiations proceeded along the lines outlined in Syosset's April 1983 amended bid until Syosset's outside counsel working on the transaction, John R. Hall, received on July 5, 1983 an undated letter from the Bank Board that was inconsistent with the terms Syosset had been seeking in two important respects. Tr. 817:10 to 818:3 (Test. of Hall); see PX 6 (Letter from Lawrence W. Hayes, Senior Associate General Counsel, FHLBB, to Hall). In that letter, the Bank Board agreed that FSLIC's cash contribution and the resulting goodwill would count toward computing Suffolk Phoenix's net worth, but the Bank Board specified a thirty-five year amortization period in lieu of the forty-year period Syosset proposed. PX 6 at 6; Tr. 117:3-13 (Test. of Fuster); Tr. 818:4-19 (Test. of Hall). The letter further stated the Bank Board's understanding that such accounting treatment was allowed by regulatory accounting principles ("RAP") rather than GAAP. PX 6 at 6; Tr. 117:3 to 118:11 (Test. of Fuster). Syosset did not consent to these terms.

Instead, Mark Fuster, Syosset's senior vice president, treasurer, and chief financial officer, made handwritten changes to a draft of the Assistance Agreement that Syosset received from FSLIC to reflect the terms that Syosset had originally proposed. Tr. 124:25 to 133:12 (Test. of Fuster); PX 87 (draft Assistance Agreement (date illegible)); PX 7 at GTP0031225-26 (Fuster's handwritten changes to draft Assistance Agreement); PX 502 (demonstrative of Fuster's handwritten changes to draft Assistance Agreement in typewritten form). In pertinent part, Mr. Fuster proposed that changes be made to the accounting section, Section 10, specifying that the applicable accounting principles would include those "in effect for mergers and acquisitions prior to the issuance of FASB # 72, permitting the use of 'push down accounting' as noted in R Memorandum # 55 and those accounting principles used by [Syosset] prior to this agreement." PX 7 at GTP0031225; PX 502. Mr. Fuster informed the regulators of these requested changes at a meeting between representatives of Syosset and the government held in July 1983 at the Bank Board's Washington, D.C. offices. Tr. 133:13 to 134:16 (Test. of Fuster); 818:21 to 821:7 (Test. of Hall). The regulators accepted Mr. Fuster's terms and added his proposed language to a draft dated July 13, 1983 and to the final Assistance Agreement. Tr. 134:17-19, 135:6 to 136:2 (Test. of Fuster); PX 90 at 19 (draft Assistance Agreement (July 13, 1983)); PX 1 at 19-20 (executed Assistance Agreement (Aug. 17, 1983)).

In connection with the transaction, Suffolk Phoenix converted to a federal stock savings bank and changed its name to The Long Island Savings Bank of Centereach FSB. PX 1 at 1. Syosset acquired Centereach as a wholly owned subsidiary by paying

$100,000 cash for all of Centereach's stock. *Id.* Pursuant to the assistance agreement entered by the parties, FSLIC paid $75 million to Centereach as a direct contribution to the bank's net worth, *id.* § 3(a), and FSLIC paid Syosset $63 million in the form of a five-year promissory note in exchange for an ICC in the same amount issued by Syosset. *Id.* § 5(b). In return, Syosset assumed responsibility for the $62 million of outstanding ICCs and NWCs that Suffolk Phoenix had issued. *Id.* § 9(c)(3)-(4). Syosset was further obligated to maintain Centereach's net worth at one percent of Centereach's liabilities for ten years following the date of acquisition, after which period Syosset would maintain the subsidiary's net worth at the level required by regulation for institutions insured for twenty years or more. *Id.* § 9(a).

Syosset applied the push-down method to account for the acquisition, and Centereach recorded approximately $625.4 million of goodwill on its books, records, and audited financial statements, which amount was to be amortized over forty years by the straight-line method. Tr. 155:9 to 156:19 (Test. of Fuster); PX 105 at LIP0828908, LIP0828910 (Centereach's Explanation of Purchase Accounting Transactions (Aug. 17, 1983)); PX 109 at GTP0097041-42 (the banks' Consolidated Financial Statements (1983 & 1982)). Absent the ability to include this massive amount of goodwill in the computation of Centereach's regulatory capital, Centereach would have had a negative net worth of approximately $550 million and, on a consolidated basis, would have overwhelmed Syosset's retained earnings. Tr. 156:23 to 157:1 (Test. of Fuster). As required by the Bank Board's resolution approving the transaction, Syosset submitted a letter from its independent accounting firm, Peat, Marwick,

Mitchell & Co., opining that the acquisition had been accounted for in accordance with GAAP. PX 9 (Letter from Nacos to Vigna attaching accountant's letter (Nov. 17, 1983)). The supervisory agent at the Bank Board received that opinion letter and found it to be acceptable. Tr. 2147:20 to 2148:5 (Test. of Vigna).

Syosset's and Centereach's Successful Operations

On a consolidated basis, Syosset's acquisition of Centereach enabled Syosset to increase its branch network fourfold, from twelve to forty-eight branches, and to grow its assets more than threefold, from approximately $1.2 billion to $4.1 billion. PX 104 at LIP0000045-46 (Nacos's copy of closing binder entitled "Acquisition of Suffolk County Federal Savings and Loan Association" (Aug. 17, 1983)); PX 109 at GTP0097037 (the banks' Consolidated Financial Statements (1983 & 1982)). After Syosset's acquisition of Centereach, the two banks operated with separate accounts but were effectively run in tandem, with almost identical board members and officers, and with a single loan department. Tr. 1155:25 to 1158:6 (Test. of Viklund). The two banks' operations were virtually indistinguishable, with only the fine print on signage and filigree denominating either Syosset or Centereach. See *id.* Operating pursuant to a very conservative philosophy, the banks lended locally to buyers of single-family homes and one- to four-unit properties. Tr. 657:15 to 658:10 (Test. of Fuster); Tr. 3913:19 to 3914:21, 3915:10 to 3917:16 (Test. of Conway). The banks developed a practice of selling fixed-rate loans into the secondary market while keeping floaters, or adjustable-rate loans. Tr. 1361:21 to 1365:18 (Test. of Singer); Tr. 5609:4-17 (Test. of Fuster). Their purpose was to keep themselves "asset-sensitive,

which means your assets reprice faster than your liabilities." Tr. 1365:8-9 (Test. of Singer). The banks, through Centereach, had also kept a folio of deeply discounted loans acquired with the Suffolk Phoenix transaction. Those loans had a substantial mark-to-market gain that was being accreted over the life of the assets. Tr. 1365:21 to 1366:14 (Test. of Singer). The banks also developed some new lines of business, especially home-equity loans at floating rates, that proved to be excellent assets for the bank. Tr. 1364:15 to 1365:11 (Test. of Singer). They also issued a few student loans. Tr. 5607:8-11 (Test. of Fuster).

As the years passed, the consolidated statements of the banks' financial condition show that the tangible-capital deficit in Centereach was gradually being reduced by retained earnings. See PX 109; PX 125 (the banks' Consolidated Financial Statements (1984 & 1983)); PX 130 (the banks' Consolidated Financial Statements (1985 & 1984)); PX 141 (the banks' Consolidated Financial Statements (1986 & 1985)); PX 145 (the banks' Consolidated Financial Statements (1987 & 1986)); PX 152 (the banks' Consolidated Financial Statements (1988 & 1987)); PX 180 (the banks' Consolidated Financial Statements (1989 & 1988)). Between 1983 and 1989, Syosset and Centereach on a consolidated basis increased their total assets from $4.1 billion to $5.3 billion and total deposits from $3.2 billion to $4.4 billion. Compare PX 109 at GTP0097037, with PX 180 at LIP0017412. The banks further expanded their operations in April 1986 with the FSLIC-assisted acquisition of Flushing Federal Savings and Loan Association, which had approximately $422 million in assets and eight branches located in Queens, Nassau, and Suffolk counties. PX 145 at

LIP0148358-59 (the banks' Consolidated Financial Statements (1987 & 1986)); Tr. 214:12-22 (Test. of Fuster); Tr. 1006:14 to 1007:3 (Test. of Viklund). During the same period, the banks unsuccessfully sought other acquisitions, and they closed or sold several branches located outside the Long Island tri-county area. Tr. 215:24 to 216:25 (Test. of Fuster); Tr. 1009:19 to 1011:3, 1014:17 to 1015:12 (Test. of Viklund); PX 131 (Minutes of Syosset's board meeting (Nov. 11, 1985)); PX 154 (Syosset's proposal to acquire four branches of Goldome (Oct. 24, 1988)).

The Advent of FIRREA

The enactment of FIRREA on August 9, 1989 eliminated or phased out the ability of thrifts to count goodwill toward regulatory capital.[7] On November 8, 1989, OTS promulgated interim regulations implementing the new capital requirements to take effect on December 7, 1989. 54 Fed. Reg. 46,845 (Nov. 8, 1989). In addition, on November 6, 1989, OTS issued Thrift Bulletin 36, which stated that a thrift that failed any one of the minimum capital requirements would be subject to "more than normal supervision" and to certain growth restrictions. DX 292 at LIP134538 (Letter from Vigna to Centereach's board of directors and

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[7] FIRREA mandated new capital standards as follows: "tangible" capital was to be maintained at a level "not less than 1.5 percent of the savings association's total assets," "core" capital was required to be "not less than 3 percent" of total assets, and "risk-based" capital was required to be kept at a level not "materially" lower than that required for national banks. 12 U.S.C. § 1464(t)(2). Supervisory goodwill and other unidentifiable intangible assets could not be counted towards tangible capital and were to be phased out of calculations for "core" capital by 1995. 12 U.S.C. § 1464(t)(3)(A), (t)(9)(A)-(C).

managing officer attaching copies of Thrift Bulletins 36 and 36-1 (Dec. 18, 1989)). A thrift that failed one or more of the capital requirements was required, among other things, to submit to OTS a "capital plan" demonstrating that it would achieve capital compliance no later than December 31, 1994. *Id.* at LIP134539.[8]

Subsequent to passage of FIRREA, Centereach had on its books approximately $492 million of supervisory goodwill, of which amount approximately $458 million was rendered immediately non-qualifying by the capital standards imposed by FIRREA. Tr. 224:16-20, 244:19 to 245:23 (Test. of Fuster); PX 26 Revised (Demonstrative summarizing Centereach's core capital position from 1989 through 1993 including goodwill). With FIRREA, Centereach's capital ratio plummeted from more than 8% positive to a negative 11%. Tr. 224:11-15 (Test. of Fuster); PX 21 (Summary of Centereach's quarterly regulatory capital ratios (1985-89)). By contrast, Syosset exceeded the new capital requirements. PX 205 at 1 (Internal OTS mem. from John Robinson through Jonathan Fiechter and John Downey (April 30, 1990)). Combined, the banks would have had negative $29 million of tangible capital. *Id.* at 2. As a consequence of Centereach's capital position, it retained the investment banking firm of Goldman Sachs & Co., DX 301 at 21 (Capital Plan for Centereach (Jan. 8, 1990)); Tr. 290:23 to 291:7 (Test. of Fuster), and submitted a capital plan

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[8] A non-compliant thrift was also given the option of applying for either a temporary "capital exception" (available only in "extraordinary situations"), or a "capital exemption" from specific provisions (which exemption had to "be accompanied by an acceptable capital plan"). DX 292 at LIP134538-39.

to OTS on January 8, 1990 in accord with Thrift Bulletin 36. DX 301. Because the plan did not demonstrate that Centereach would achieve capital compliance by December 31, 1994, OTS informed Centereach that the plan was unacceptable and would be rejected, and Centereach withdrew it. *Id.* at 14; PX 197 (Internal OTS mem. from Joseph P. Kehoe, Assistant Director, OTS, to Vigna (Feb. 20, 1990)); DX 83 at 7-8 (Minutes of Syosset's board of trustees meeting (Sept. 25, 1990)); Tr. 292:7-18 (Test. of Fuster).

Centereach's Capital Plan

Over the next several months, OTS engaged in internal discussions about whether to require Syosset and Centereach to file a capital plan on a consolidated basis, and OTS eventually decided to require consolidation. PX 197; PX 199 at GTP0033235-38 (Minutes of meeting of Supervisory Policy Committee (Mar. 21, 1990)); PX 203 (Internal OTS mem. of oral communication between Kehoe and James Caton (Apr. 19, 1990)); PX 205 (Internal OTS mem. from John Robinson through Jonathan Fiechter and John Downey (Apr. 30, 1990)). At meetings between the parties held in April and May 1990, the banks urged OTS not to require the banks to consolidate, which would result in two capital-deficient institutions rather than just one, but Long Island did indicate its willingness to supplement Centereach's capital plan and to strengthen Centereach's capital position. DX 317 (Internal OTS mem. from Ruth Ann Popielarski to the files (May 1, 1990)); PX 208 (Letter from Viklund to Vigna supplementing meeting held on April 27, 1990 (May 1, 1990)); PX 11 (Internal OTS mem. from Kehoe to the files (May 8, 1990)). Following those meetings,

OTS ultimately relented on its position regarding consolidation. PX 12 (Memorandum from Jonathan L. Fiechter, Principal Senior Deputy Director, OTS, to Vigna (Aug. 8, 1990)); PX 212 (Letter from Vigna to Viklund (Aug. 24, 1990)); DX 83 at 7-8 (Minutes of Syosset's board of trustees meeting (Sept. 25, 1990)). On October 25, 1990, Centereach submitted a second capital plan, pursuant to which Syosset would make additional capital contributions to Centereach through 1994, PX 13 at 32-34 (Capital Plan for Centereach (Oct. 25, 1990)), and Centereach would "determine later the precise further actions to be taken in 1994 (or thereafter), depending on the economic, regulatory, legal and other circumstances at the time." *Id.* at 42.

Centereach submitted to OTS further amendments to its capital plan in December 1990 and April 1991, PX 225 (Letter from Conway to David R. Dorgan, Senior Assistant Director, OTS (Dec. 18, 1990)); DX 1565 (Letter from Nacos to Michael Simone, Assistant District Director, OTS (Apr. 25, 1991)), and it received conditional approval in May 1991. DX 1571 (Letter from Vigna to Centereach's board of directors (May 22, 1991)). In October 1991, Centereach submitted another amendment containing amended projections, DX 389A (Letter from Conway to Rohrs (Oct. 30, 1991)), and OTS granted final conditional approval several days later. DX 387 (Letter from Angelo A. Vigna, then-Northeast Regional Director, OTS, to Centereach's board of directors (Oct. 30, 1991)). As Thrift Bulletin 36 provided, the effect of such approval was to allow Centereach to continue to operate so long as it stayed in compliance with the capital plan, *i.e.*, continued moving toward capital compliance. See DX 292 at LIP134538 (Letter from

Angelo A. Vigna, then-District Director, OTS-New York, to LISB's board of directors and managing officer attaching copies of Thrift Bulletins 36 and 36-1 (Dec. 18, 1989)).

In April 1991, Centereach's MACRO rating was decreased from a composite rating of 2 to a composite rating of 4 "result[ing] from the institution's insolvent regulatory capital position." PX 249 (Letter from Vigna to Nacos (Mar. 25, 1992)); see also Tr. 286:1-20, 287:15 to 288:6 (Test. of Fuster); PX 35 (Demonstrative summarizing ratings for Syosset, Centereach, and Long Island Bancorp, Inc.); PX 35A (supporting materials for PX 35).[9] "Because of the assigned MACRO rating, Centereach [wa]s considered a troubled institution and [had to] pay the premium assessment as indicated in Thrift Bulletin 48." PX 249. Centereach's capital deficiency also caused Fannie Mae and Freddie Mac to notify Centereach that it could no longer be a seller-servicer. Tr. 286:21 to 287:8 (Test. of Fuster).

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[9] The financial regulatory entities use a rating system, initially known by the "MACRO" acronym, and after FIRREA as "CAMEL," to evaluate the viability and strength of banks. See *Globe Sav. Bank, F.S.B.* v. *United States*, 65 Fed. Cl. 330, 339 n. 6 (2005). The MACRO assessment evaluated the effectiveness of management and the board of directors, along with asset quality, capital adequacy, asset/liability and risk management, and earnings (operations). The CAMEL assessment addresses the same topics but refers to them as capital, assets, management, earnings, and liability. A rating of "1" is the highest rating, and a rating of "5" is the lowest. A composite "4" rating indicates that the institution "generally exhibit[s] unsafe and unsound practices or conditions" and has "serious financial or managerial deficiencies that result in unsatisfactory performance." 61 Fed. Reg. 67021, 67026 (Dec. 19, 1996).

On December 19, 1991, Congress enacted the Federal Deposit Insurance Corporation Improvement Act of 1991, Pub. L. No. 102-242, 105 Stat. 2236 (1991) (codified at 12 U.S.C. §§ 1811-34b) ("FDICIA"). Section 131 of FDICIA added Section 38 to the Federal Deposit Insurance Act, entitled "Prompt Corrective Action," establishing five new capital categories for insured depository institutions: "well capitalized," "adequately capitalized," "undercapitalized," "significantly undercapitalized," and "critically undercapitalized." *Id.* § 131A, 105 Stat. at 2253 (codified at 12 U.S.C. § 1831o). On September 29, 1992, final rules implementing that section were adopted by the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, FDIC, and OTS. 57 Fed.Reg. 44866-901 (Sept. 29, 1992) (codified in part at 12 C.F.R. §§ 208.33 (Federal Reserve Board), 325.103 (FDIC) and 565.4(OTS) (1993)). The final rules became effective December 19, 1992, which was also the effective date of Section 131 of FDICIA. The regulations defined the five capital categories in terms of minimum capital ratios. See, *e.g.*,12 C.F.R. § 565.4(b) (1993).[10] In addition, the regulations set out

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[10] Under these regulations, a bank was "[w]ell capitalized" if the bank: "(i)[h]a[d] a total risk-based capital ratio of 10.0 percent or greater; and (ii)[h]a[d] a Tier 1 risk-based capital ratio of 6.0 percent or greater; and (iii)[h]a[d] a leverage ratio of 5.0 percent or greater." 12 C.F.R. § 565.4(b)(1) (1993). The corresponding ratios for an "[a]dequately capitalized" bank were 8.0, 4.0, and 4.0, except that a leverage ratio of 3.0 or greater sufficed "if the bank [wa]s rated composite 1 under the MACRO rating system" and "[d]oes not meet the definition of a well capitalized savings association." *Id.* § 565.4(b)(2).

An "[u]ndercapitalized" bank had corresponding ratios less than 8.0, 4.0, and 4.0, except that such a bank could also have a leverage ratio of less than 3.0 if it maintained a composite

sanctions applicable to institutions deemed to be undercapitalized, significantly undercapitalized, or critically undercapitalized. *Id.* § 565.6.[11]

On November 16, 1992, OTS sent a letter to Centereach stating that Centereach would have been deemed critically undercapitalized based on its June 30, 1992 Thrift Financial Report data, had the prompt corrective action provision of FDICIA been effective at that time. PX 281 (Letter from Vigna to Centereach's board of directors (Nov. 16, 1992)). Three days after that provision took effect, OTS sent Centereach notice that Centereach's capital ratios placed it in the critically undercapitalized category. PX 293 (Letter from Vigna to Centereach's board of directors (Dec. 22, 1992)).

The Restructuring

In April 1992, several months after FDICIA was enacted, Mr. Viklund asked Mr. Fuster and William D. Singer, the banks' chief investment officer, to develop a restructuring plan for bringing Centereach

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rating of 1 under the MACRO System and was not significantly growing. *Id.* § 565.4(b)(3). A "[s]ignificantly undercapitalized" bank had ratios less than 6.0, 3.0, and 3.0. *Id.* § 565(b)(4). A "[c]ritically undercapitalized" bank had a "ratio of tangible equity to total assets that [wa]s equal to or less than 2.0 percent." *Id.* § 565(b)(5).

[11] Such a bank became subject to the provisions of 12 U.S.C. § 1831o(d), (e)(1), (e)(2), (e)(3), and (e)(4), restricting payment of capital distributions and management fees, requiring that the banking agency monitor the condition of the bank, requiring submission of a capital restoration plan, restricting the growth of the bank's assets, and requiring prior approval of certain expansion proposals. 12 C.F.R. § 565.6(a)(2) (1993). In addition, the compensation paid to senior executive officers could be restricted. See *id.* § 565.6(a)(3).

at least into the well-capitalized capital category under FDICIA. Tr. 339:18 to 340:18 (Test. of Fuster); Tr. 1076:1 to 1077:5 (Test. of Viklund); Tr. 1344:19 to 1345:13 (Test. of Singer). Messrs. Fuster and Singer concluded that in addition to reducing borrowings, realizing embedded profits in assets, and writing off its remaining goodwill, Centereach would have to shrink and sell deposits. Tr. 340:19 to 341:15 (Test. of Fuster); Tr. 1345:17 to 1346:25 (Test. of Singer). Initially, the banks' management envisioned shrinking only Centereach, but at Mr. Nacos's suggestion it also considered shrinking both Centereach and Syosset. Tr. 341:16 to 342:1 (Test. of Fuster); see also Tr. 1345:19 to 1346:15 (Test. of Singer). This strategy was considered because, although Centereach was progressing ahead of the projections of its capital plan, the banks' management realized that Centereach could not achieve capital compliance on its own. Tr. 342:2 to 344:3 (Test. of Fuster); PX 518 (Demonstrative showing capital still needed by Centereach after mitigation efforts to June 30, 1992). Mr. Fuster and his staff additionally considered and rejected merging the two banks without shrinkage, concluding that it was not reasonable to sacrifice Syosset's favorable capital position in a circumstance in which the resulting entity would still be subject to a capital plan. Tr. 344:25 to 345:8 (Test. of Fuster).[12]

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[12] Messrs. Fuster, Singer, and other members of the banks' management briefly considered a possible sale of Centereach to, or merger of Centereach with, a healthy banking institution but rapidly abandoned that option because of Centereach's significant tangible-capital deficit. Tr. 344:12-24 (Test. of Fuster). They did not consider conversion to a stock company. Tr. 345:9 to 346:12 (Test. of Fuster). Mr. Fuster testified that "[t]he only motivation we had in developing [the restructuring]

In August 1992, a restructuring committee of the banks was formed and selected the investment banking firm of Bear, Stearns & Co. ("Bear Stearns") to prepare a restructuring analysis. PX 260 at 1 (Minutes of restructuring committee meeting (Aug. 24, 1992)); see also PX 263 at 4 (Syosset's board of trustees meeting (Sept. 22, 1992)); PX 269 (Letter from Robert A. Baer, Jr., Senior Managing Director, Bear Stearns, to Viklund confirming the banks' engagement of Bear Stearns (Oct. 21, 1992)); Tr. 346:17 to 347:2 (Test. of Fuster). Bear Stearns performed its due diligence during September and October of 1992, Tr. 350:2-4 (Test. of Fuster); PX 261 (Preliminary due diligence request list from Bear Stearns to Syosset (Aug. 25, 1992)), and presented its final restructuring analysis and recommendation to the banks' boards the following month. PX 14 (Presentation on Restructuring Alternatives (Nov. 19, 1992)); PX 283 at LIP0119461-68 (Minutes of Centereach's board of directors meeting (Nov. 19, 1992)). The plan recommended by Bear Stearns involved achieving a targeted 5.25% capital ratio by selling branches with $1.0 billion of deposits, funded by the sale of $1.25 billion of securities and loans, paying down other borrowings of $250 million, merging Centereach and Syosset, and writing off goodwill. PX 14 at GTP0057159, GTP0057162-63; PX 283 at LIP0119463-64. Bear Stearns considered and

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plan was to get rid of the capital plan." Tr. 346:15-16 (Test. of Fuster). The banks explicitly rejected the proposal of one investment advisor, Sandler O'Neill, which at that time (August 1992) focused more on making a proposal to buy the bank themselves or take it public through a conversion. Tr. 1355:2-23 (Test. of Singer) ("We had no desire to go public. Our desire was to solve our capital problem and grow the company and manage it, as we had managed it for a number of years.").

rejected several restructuring alternatives, including a targeted capital ratio of 5%, because that option would not provide for any capital cushion whatsoever. PX 14 at GTP0057159. In addition, Bear Stearns analyzed and rejected targeting a 6% capital ratio, which alternative would result in a severe impact on future earnings and a high expense ratio. *Id.*

Following Bear Stearns's presentation, the banks' boards decided to implement Bear Stearns's recommended plan. PX 283 at LIP0119469; Tr. 935:5-18 (Test. of Donald Wenk, chairman of Syosset's board of directors, succeeding Conway); Tr. 1437:13-25 (Test. of John J. Conefry, chairman of Syosset's board of directors and chief executive officer at relevant times). The banks submitted their restructuring plan to OTS on November 23, 1992, DX 1657 (Letter from Viklund to Vigna (Nov. 23, 1992)), and the following month OTS provided written notice that it did not object to that plan and considered the proposed restructuring an acceleration of the resolution of Centereach's capital deficiency addressed in Centereach's capital plan. PX 297 (Letter from Vigna to Centereach's board of directors (Dec. 23, 1992)).

In furtherance of their restructuring plan, Centereach and Syosset began paying down borrowings, selling assets, and taking preparatory steps to sell branches. Based on the earlier work of Messrs. Fuster and Singer, as examined and verified by Bear Stearns, the banks knew they would have to sell a significant volume of their better earning assets to fund the sale of the branches. On behalf of the banks, Mr. Singer began selecting and assembling sizable packages of loans and mortgage-

backed securities for sale and making sales. Tr. 1363:19 to 1364:14 (Test. of Singer). As to the branches, the banks initially considered selling branches clustered in particular locations, but ultimately developed a list of twenty branches that could be sold, with the buyer to pick ten branches from this list. Tr. 735:17 to 736:21 (Test. of Fuster).

In due course, in April 1993 Syosset and Centereach entered into an agreement in principle with Home Savings of America ("Home Savings") to sell to the latter thrift ten branches in the tri-county area which then had approximately $950 million of deposits. PX 309 (Joint press release of Home Savings and the banks (Apr. 29, 1993)). The three banks entered into a Purchase of Assets and Liability Assumption Agreement in June 1993, pursuant to which Home Savings would purchase five branches of Syosset and five branches of Centereach. PX 311 at GTP0069185 (Purchase of Assets and Liability Assumption Agreement (June 9, 1993)). The parties to the transaction submitted a joint application to OTS in July 1993, and OTS conditionally approved the application the following month. PX 327 (Letter from Thomas F. Sharkey, Assistant Regional Director, West Region, OTS, to William J. Wiley, Vice President, Home Savings, and Nacos (Aug. 4, 1993)). Closing the deal on September 3, 1993, Syosset and Centereach paid Home Savings $817,195,112 to assume $836,253,302 of deposits. PX 333 at GPT0069110 (Summary of branch sale accounting (Sept. 3, 1993)); DX 606 at 5, 33 (Long Island Bancorp, Inc.'s Prospectus (Feb. 14, 1994)).[13]

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[13] Non-compete covenants in the branch sale agreement with Home Savings limited future growth through deposit

Concurrently with this transaction, Syosset merged into Centereach, a "reverse" merger of the parent into the subsidiary, and the resulting entity took the name The Long Island Savings Bank, FSB ("Long Island" or "Bank"). PX 324 (Letter from Vigna to Viklund granting conditional approval of Centereach's application to convert to mutual charter and acquire by merger Syosset (July 30, 1993)); PX 325 (Letter from Vigna to Viklund granting conditional approval of Centereach's application to transfer Syosset's Assistance Agreement to Centereach (July 30, 1993)); PX 335 (Memorandum from Viklund to Long Island's employees (Sept. 7, 1993)); DX 606 at 5, 33.[14] In connection with the merger, Long Island adopted SFAS 72 and wrote off its remaining goodwill balance, resulting in a charge of approximately $442 million to earnings in the Bank's fiscal year that ended September 30, 1993. Tr. 365:8-25 (Test. of Fuster); PX 519 (Demonstrative showing Long Island's goodwill write-off); DX 606 at 5, 33, F-8. Because the merger succeeded in making the surviving entity well capitalized for purposes of FDICIA, albeit barely, on September 3, 1993, OTS terminated Centereach's capital plan. PX 332 (Letter from Vigna to Long Island's board of directors (Sept. 3, 1993)).

To fund the branch-sale payment made to Home Savings, Bear Stearns had initially projected that

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acquisitions in certain counties until 1996. Tr. 598:16-23 (Test. of Fuster).

[14] The complaint in this action was filed on August 3, 1992, more than a year prior to the merger on September 3, 1993. Because of this sequential timing, Long Island's predecessors, Syosset and Centereach, are the plaintiffs named in the suit.

Syosset and Centereach would need approximately $1.1 billion. DX 926 at PLI169 1556 (Bear Stearns's presentation to the Special Committee of Long Island (Sept. 29, 1992)). Following the announcement in April 1993 of the sale of the ten branches, however, those branches experienced deposit runoff in the amount of approximately $114 million, reducing their total deposits to approximately $836 million. Tr. 5498:10 to 5499:11 (Test. of Dr. Nevins Baxter, an expert witness for plaintiffs); PX 803 (Demonstrative showing deposit runoff in the sold branches); PX 333 at GPT0069110 (Summary of branch sale accounting (Sept. 3, 1993)). Because of that runoff, Mr. Singer sold more assets than the amount that ultimately became necessary. Tr. 5606:9-22 (Test. of Fuster).

The banks sold a variety of assets. They sold their portfolio of student loans to Sallie Mae. They securitized and sold approximately $300 million of home equity lines of credit ("HELOCs") (on which the banks retained servicing). They also securitized and sold a package of fixed-rate whole loans, (in which the banks retained some servicing rights), and sold a portfolio of mortgage-backed securities, together totaling approximately $272 million. See Tr. 359:4-15, 5601:1-11, 5602:10 to 5603:6, 5607:3 to 5608:20 (Test. of Fuster); Tr. 1364:2-14, 1365:21 to 1366:4, 1370:10 to 1377:2 (Test. of Singer); PX 296 (Letter from Singer to Simone (Dec. 23, 1992)); DX 926 PLI169 1556; PX 14 at GTP0057163 (Presentation on restructuring alternatives (Nov. 19, 1992)). The banks would not have sold the HELOCs but for the restructuring, because those loans produced a favorable net interest margin with a relatively short duration. Tr. 360:2-14 (Test. of Fuster); Tr. 1364:15 to 1365:11 (Test. of Singer). Likewise, the agency

mortgage-backed securities and whole loans would not have been sold in the ordinary course because Long Island "could not replace them in the market at the current yield that they were throwing off." Tr. 1366:5-14 (Test. of Singer). Some of those loans and securities had been marked to market at a discount in connection with the Suffolk Phoenix transaction, and Centereach had been amortizing gains on those marked-to-market loans and securities, but market-related gains were realized upon their sale. Specifically, the sale of these assets produced an accretion gain of approximately $41 million and a $3 million gain on a cash basis. PX 296; Tr. 1365:23 to 1366:4 (Test. of Singer); Tr. 5609:23 to 5611:4 (Test. of Fuster). The banks invested the proceeds of the sales in short-term securities in anticipation of the need to fund the branch sale, and it retained the securities to the extent it did not need the funds for the branch sale. Among other things, it expanded its portfolio of U.S. Treasury securities. PX 391 at 44 (Long Island Bancorp, Inc.'s annual report (1994)).

Immediately prior to the branch sale and merger, on August 31, 1993, the capital ratio of the banks on a consolidated basis was 4.26%, an improved but still insufficient ratio that reflected the sale of assets and reduction in borrowings to prepare for the branch sale. Tr. 368:6 to 369:5 (Test. of Fuster); PX 520 (Demonstrative showing tangible-capital ratios of banks before and after restructuring). Subsequent to the branch sale and merger, on September 30, 1993, the Bank's capital ratio was 5.31%, i.e., only 0.31% above the minimum ratio for the well capitalized level. Tr. 369:6-12 (Test. of Fuster); PX 520.

OTS and FDIC conducted examinations of the banks commencing prior to their restructuring and

concluding subsequent to the restructuring and their merger. PX 15 (FDIC's report of examination (commenced July 6, 1993)); PX 328 (OTS report of examination (commenced Aug. 11, 1993)). Representatives of both regulatory entities met with Long Island's board of trustees on October 26, 1993 to present the findings of their respective examinations. PX 15 at GTP0056285; PX 328 at 3; PX 16 at 7-10 (Long Island's board of trustees meeting (Oct. 26, 1993)). OTS indicated in its report that "[t]he principal area of concern is asset quality as the level of delinquencies in the various loan portfolios remains high," PX 328 at 1, and that asset quality is "considered less than satisfactory." *Id.* at 5. Despite this finding with respect to the MACRO factor of asset quality, OTS informed Long Island that OTS assigned the Bank a composite MACRO rating of "2." PX 328 at 2; PX 15 at GTP0056285; PX 16 at 8; Tr. 369:23 to 370:3 (Test. of Fuster); PX 35 (Demonstrative summarizing ratings for Syosset, Centereach, and Long Island Bancorp, Inc.); PX 35A (supporting materials for PX 35) at PX035A-0026 (Letter from Rohrs to Long Island's board of directors (Oct. 28, 1993)).

For its part, FDIC agreed with OTS that Long Island's level of nonperforming assets posed a problem; however, FDIC considered the problem so serious as to disqualify the Bank from a composite "2" rating. FDIC observed at the meeting that the restructuring and merger "had brought capital up to 5%, but in the process, the Bank had to sell some high earning and good assets." PX 16 at 9; see also PX 15 at GTP0056283 (stating FDIC's opinion that "[a]lthough capital is now above regulatory requirements, the volume of marginal and inferior quality assets remains at a high level and will

continue to have a negative impact on earnings performance in the future"); *id.* at GTP0056285 (FDIC's representatives informing Long Island that in FDIC's view, "[t]he asset sale transaction was seen as negatively impacting future earnings performance"). Consequently, FDIC assigned Long Island a composite rating of "3." PX 15 at GTP0056285; see also PX 16 at 9.

In an effort to increase its capital ratio subsequent to the merger in the circumstance of the Bank's shrinkage by 20%, and coincidentally to improve its MACRO rating, Long Island began to look internally to reduce expenses, Tr. 372:2-16 (Test. of Fuster), and to dispose of non-earning assets. Tr. 387:9 to 388:2 (Test. of Fuster); see also Tr. 368:23 to 369:22 (Test. of Fuster). In that connection, as FDIC observed in its report of examination, Long Island's "short term goal for fiscal 1994 is to reach a tangible equity to assets ratio of 6.00%." PX 15 at GTP0056283 (FDIC's report of examination of Long Island (commenced July 6, 1993)); see also DX 441 at 4 (Long Island's Corporate Strategic Plan & Operating Budget for the Fiscal Year Ending Sept. 30, 1994 (Sept. 28, 1993)); Tr. 384:13 to 386:9 (Test. of Fuster). Although Long Island's short-term goal was to achieve a 6% tangible-capital ratio, Long Island's board wanted to operate the Bank at a capital ratio of 8% to 9%, the level at which the banks had been operating pre-FIRREA. Tr. 372:17 to 373:4 (Test. of Fuster); Tr. 1122:18-20 (Test. of Viklund); see also PX 21 (Demonstrative summarizing Centereach's/Syosset's quarterly regulatory capital ratios from 1985 through 1998); PX 22 (Demonstrative summarizing Syosset's quarterly regulatory capital ratios from Dec. 1985 through June 1993).

To improve its risk profile, Long Island sought to put together a package of its nonperforming and underperforming loans and a separate package of its real estate owned, such that the packages might be sold in bulk. Tr. 387:9 to 388:2 (Test. of Fuster). At the time, Long Island's officers were concerned that the losses incurred on such a sale might drop Long Island's tangible-capital ratio below the FDICIA well-capitalized level. Tr. 387:21-24 (Test. of Fuster). The Bank retained Merrill Lynch as its advisor for the transaction, and the Bank exercised caution to avoid too large a loss on the sale. Tr. 392:3 to 19 (Test. of Fuster); PX 352 at 8 (Minutes of Long Island's board of trustees meeting (Nov. 23, 1993)). In December 1993, Long Island entered into a contract for the bulk sale of the resulting package of nonperforming and underperforming loans (the "Bulk Sale"). Tr. 392:13-19 (Test. of Fuster); PX 391 at 19 (Long Island Bancorp, Inc.'s annual report (1994)); PX 354 at 1.1 (Conversion Valuation Appraisal Report (Dec. 17, 1993)). The real estate owned was sold separately from the Bulk Sale of the loans. PX391 at GTP0083019. As of September 30, 1993, the book value of the loans to be sold was approximately $142.0 million, and that of the real estate to be sold was about $14.0 million. PX 391 at GTP0083019; see also PX 354 at 1.3. The sale of the loans was completed by December 31, 1993, and the sale of the real estate was consummated in the second quarter of fiscal year 1994. PX 391 at GTP0083019. On September 30, 1993, the values of the assets sold in the Bulk Sale were adjusted to market based on the sales price established in the Bulk Sale. *Id.*

In sum, as a result of the Bank's restructuring actions, including sale of assets, diminution of

borrowings, the branch-deposit sale, the write-off of goodwill, the Bulk Sale, and the sale of real estate owned, the Bank's total assets declined from $5.6 billion as of September 30, 1992 to $4.0 billion as of September 30, 1993. *Id.* Long Island's tangible-capital ratio reached and remained above 5%, albeit barely. On December 31, 1993, after the Bulk Sale had been made, Long Island's tangible capital was $224.536 million and its tangible capital ratio had dropped to 5.27%. PX 423, Ex. C at 4 (Expert Report of Charles W. Calomiris (June 14, 2004)). By March 31, 1994, after the real estate owned had been sold, Long Island's tangible capital had dropped slightly more, by $296,000, to $224.240 million. *Id.*

Long Island's Conversion to a Stock Company.

Long Island's restructuring efforts did not succeed in bringing the Bank's capital ratio to the level which the Bank's management considered necessary to continue operating the institution. Tr. 939:3-13 (Test. of Wenk); see also Tr. 369:6-22, 372:17 to 373:4, 383:23 to 384:9 (Test. of Fuster); Tr. 1122:18-20 (Test. of Viklund). In August 1993, several months prior to the Bulk Sale, the Bank had formed an ad hoc committee and appointed Mr. Conefry as chair to evaluate Long Island's capital condition subsequent to its restructuring efforts and to recommend alternatives for acquiring sufficient capital. PX 329 at LIP0041916-17 (Minutes of Long Island's board of directors meeting (Aug. 24, 1993)); Tr. 939:3-23 (Test. of Wenk); Tr. 1442:11-17, 1548:1-10 (Test. of Conefry); PX 367 at LIP0181276 (Memorandum from Conefry to distribution among Long Island's directors). The committee requested reports in this regard from seven Wall Street firms, all of which advised that additional capital was

necessary and that a conversion from a mutual to a stock company was the only practicable means of raising such capital. Tr. 1443:15 to 1444:7, 1548:11 to 1549:1 (Test. of Conefry); PX 367 at LIP0181276.[15]

In accord with this advice, in November 1993, Long Island began the process of converting to a stock company. PX 349 (Minutes of Long Island's special board of trustees meeting (Nov. 16, 1993)); PX 351 at LIP0172208 (Memorandum from Wenk to Long Island's employees (Nov. 19, 1993)); PX 352 at 10 (Minutes of Long Island's board of trustees meeting (Nov. 23, 1993)). The Bank retained Merrill Lynch and Salomon Brothers Inc. to underwrite the conversion. Tr. 944:10-11 (Test. of Wenk). In addition, Long Island retained RP Financial, Inc. to provide an appraisal of the pro forma market value of the common stock to be issued by a newly formed holding company, Long Island Bancorp, Inc. ("Long Island Bancorp") and to prepare a business plan for the period through September 30, 1997. DX 1082A (Letter from Ronald S. Riggins, President and Managing Consultant, RP Financial, to Conefry confirming engagement for appraisal (Oct. 27, 1993)); PX 345 (Letter from Riggins to Conefry confirming engagement for business plan (Oct. 27, 1993)); PX 354 (Conversion Valuation Appraisal Report (Dec. 17, 1993)); PX 357 (Business Plan (Dec. 30, 1993)).

Long Island's conversion was "motivated by the need for capital [,a]pproximately three hundred million dollars of [which] capital need can be attributed to the government mandated write-off of

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[15] The seven firms were Merrill Lynch, Salomon Brothers, Goldman Sachs, Bear Stearns, Smith Barney, Sandler O'Neil, and Adams & Cohen. PX 367 at LIP0181276.

supervisory goodwill and the related divestiture of 20% of the bank's business for the purposes of complying with a government mandated capital plan." PX 367 at LIP0181276 (Memorandum from Conefry to distribution among Long Island's directors (Feb. 24, 1994)); accord Tr. 1446:20 to 1447:4 (Test. of Conefry); Tr. 1382:9 to 1383:11 (Test. of Singer). As Merrill Lynch advised the Bank, "[i]ncreased capital provides greater operating flexibility and a cushion against unanticipated losses." PX 331 at LIP0155255 (Merrill Lynch's presentation to Long Island (Sept. 1993)). Long Island's management believed that raising capital via a conversion would assist the Bank in competing with its peers, provide access to additional capital markets, and strengthen its customer services, lending, and investment operations. PX 349 at LIP0091182 (Minutes of Long Island's special board of trustees meeting (Nov. 16, 1993)); see also Tr. 1447:5-11 (Test. of Conefry). Mr. Fuster testified that Long Island could not have competed effectively in its market while it was only minimally in compliance with capital requirements:

> Q. [Mr. Infelise] ... [I]t's true isn't it that Long Island Savings Bank's decision to convert from a mutual to a thrift [stock] institution in April of 1994 was not necessary for Long Island Savings Bank to attain capital compliance, was it?
>
> A. [Mr. Fuster] While the bank may have been in compliance at the point that it converted, it certainly was only minimally in compliance and could not realistically grow or compete without the ability of having additional capital.

Tr. 764:3-11 (Test. of Fuster). OTS indicated that it was "very pleased" with Long Island's plans for conversion and an initial public offering ("IPO"). Tr. 1489:14 to 1490:4 (Test. of Conefry); see also PX 349 at LIP0091182.

The appraisal evaluation for the conversion was done by Mr. Ronald Riggins of RP Financial. The original appraisal was completed on December 17, 1993, and filed with OTS. PX 354 (Conversion Valuation Appraisal Report for The Long Island Savings Bank, FSB (Dec. 17, 1993)); Tr. 1650:9 to 1654:11 (Test. of Riggins). That report indicated that the estimated midpoint of the pro forma market value of the to-be-issued common stock was $225,000,000, based on the proposed issuance of 22,500,000 shares at $10.00 a share. *Id.* at LIP0035247. The valuation was principally driven by Mr. Riggins' assessment of Long Island's earning potential relative to that of a peer group. Tr. 1690:14 to 1698:5 (Test. of Riggins). See also Tr. 1658:12 to 1706:9 (Test. of Riggins). The conversion regulations contemplated establishing a range of value, from 15 percent below the appraised value (the "minimum"), to 15 percent above the midpoint (the "maximum"). OTS also provided for an upper limit, which is 15 percent above the maximum (the "super maximum"). Tr. 1655:10-16 (Test. of Riggins). The appraisal and the application for conversion were approved by OTS, a prospectus was prepared and proffered to OTS and the Securities and Exchange Commission ("SEC"), and then the prospectus was publicly issued on February 14, 1994, following the incorporation of comments by OTS and SEC. Tr. 1651:5 to 1652:2 (Test. of Riggins). After an appraisal update was issued on April 6, 1994, the public offering took place and yielded $297.6 million, the "super maximum."

Tr. 1656:5-15 (Test. of Riggins). The IPO was a so-called "community" offering, basically to Long Island's depositors, and was heavily oversubscribed; 90% of the shares were purchased by depositors and the remaining 10% were issued for Long Island's newly formed employee stock option plan and its management retention plan. Tr. 1385:6-19 (Test. of Singer); Tr. 1656:18 to 1658:11 (Test. of Riggins); PX 391 at GTP0083002 (Long Island Bancorp's 1994 annual report). The shares were sold to the depositors at $11.50 a share. Tr. 5597:6-8 (Test. of Fuster).

The conversion was completed on April 14, 1994. Tr. 392:24-25 (Test. of Fuster); PX 391 at GTP0083002 (Long Island Bancorp's annual report (1994)). Long Island Bancorp ultimately realized $296.9 million of net proceeds from the IPO, $164 million of which amount was contributed to the Bank in exchange for all of its issued and outstanding common stock. Tr. 393:22 to 394:2, 394:22-25 (Test. of Fuster); PX 521 (Demonstrative showing conversion proceeds); PX 391 at GTP0083018, GTP0083041. The Bank used $23.8 million of that contribution for an Employee Stock Ownership Plan ("ESOP") and $8.9 million for a Management Recognition and Retention Plan ("MRP"). Tr. 394:5-21 (Test. of Fuster); PX 521; PX 391 at GTP0083018, GTP0083036, GTP0083041-42. The remaining conversion proceeds of approximately $100.2 million were retained at the holding company level. The holding company was required by OTS regulations to transfer to the Bank at least 50% of the net conversion proceeds. Tr. 5579:19-25 (Test. of Fuster). That amount would have been approximately $148 million. Tr. 5580:4-6 (Test. of Fuster). However, the Bank actually transferred $164 million, more than

required, because "[t]he bank and the holding company wanted the bank to have at least an 8 percent capital ratio going into its new existence as a public company." Tr. 5580:12-14 (Test. of Fuster).

Long Island's Post-Conversion Operations and Subsequent Merger with Astoria

Following Long Island's conversion and IPO, by September 30, 1994, the Bank had achieved a tangible capital level of almost $360 million, increasing its tangible-capital ratio to 8.14%. Tr. 395:23 to 396:4 (Test. of Fuster); PX 522 (Demonstrative showing Long Island's tangible capital and tangible-capital ratio); PX 391 at GTP0083032. Through the conversion, the Bank had completed the task of replacing the goodwill lost as regulatory capital by the enactment of FIRREA. Long Island focused on its operations. In November 1994, Long Island expanded its origination business, acquiring eleven loan servicing and lending offices from Entrust Financial Corporation and a retail lending office from Developer's Mortgage Corporation, expanding such services to include Pennsylvania, Delaware, Maryland, Virginia, and Georgia. PX 394 at GTP0077838 (Long Island Bancorp's annual report (1995)). Long Island promptly began to pay a dividend. As Mr. Singer explained:

> The decision to pay dividends, the company was earning money or earning capital, the decision to pay dividends was ours because we did what was known as a community offering, which we basically offered the stock to our depositors. Depositors had taken money out of their savings and/or CD accounts and bought stock. They were

> foregoing interest on their savings, and we were paying a dividend back to them as a return of some of the, quote, what you would call, interest income that they were losing on the deposits because they had bought the stock. So we looked at it as a way of returning to them some of the interest income they would have had had they left the money in the bank as a deposit.

Tr. 1385:4-16 (Test. of Singer). The process of paying dividends had two steps. Long Island Savings Bank paid dividends to Long Island Bancorp and Bancorp paid dividends to shareholders. The Bank paid dividends to Bancorp as follows:

Fiscal year[16]	Dividend
1995	$10,800,000
1996	10,500,000
1997	20,000,000
1998	25,000,000

PX 423, Ex. D (Expert Report of Charles W. Calomiris (June 14, 2004)). Overall, Bancorp paid dividends to its shareholders and repurchased its stock[17] in the following amounts:

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[16] Long Island's fiscal year ended on September 30. See PX 404 at LIP0083715 (Long Island Bancorp annual report (1997)).

[17] On January 31, 1995, approximately nine months after Long Island's conversion, Mr. Fuster sent a letter to OTS requesting a waiver of the prohibition on stock repurchases within one year of conversion. Tr. 682:16 to 683:9 (Test. of Fuster); DX 1898 (Letter from Fuster to Douglas J. Cestone, Deputy Head of Corporate Activities, OTS (Jan. 31, 1995)). Mr. Fuster explained that Long Island Bancorp "and the Bank, because they cannot find acceptable product at desired yields, and even

	Repurchases	Dividends
Fiscal year 1995	$17,812,000	$9,693,000
Fiscal year 1996	$42,043,000	$9,171,000
Fiscal year 1997	$24,017,000	$13,378,000
Fiscal year 1998	(part year)	
	$ 6,894,000	$11,214,000[18]

PX 404 at 31 (Long Island Bancorp's annual report 1997); DX 597 at BAN0000134-36 (Long Island Bancorp's Form 10-Q (Aug. 14, 1998)); Tr. 701:20 to 705:11 (Test. of Fuster). Long Island Bancorp initially paid a quarterly dividend of 10 cents per share. PX 423, Ex. D (Expert Report of Charles W. Calomiris (June 14, 2004)). That dividend was increased to 15 cents per share in the first quarter of fiscal year 1997 and to 20 cents per share in the third quarter of 1998. *Id.* In addition to steadily increasing dividends, Long Island Bancorp's shareholders benefitted from a strong increase in the price per share of Long Island's stock, from $11.50 per share at the initial public offering in April 1994 to $47.00 per share at September 30, 1997. PX 404 at LIP0083716 (Long Island Bancorp annual report (1997)).

On April 2, 1998, an agreement and plan of merger was signed between Long Island Bancorp

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though they have declared a dividend, still have excess capital and request that this application be approved." DX 1898 at WOP776 1162-63. Long Island Bancorp's application was approved, and from fiscal year 1995 through fiscal year 1998, Long Island Bancorp carried out a stock repurchase program.

[18] Bancorp apparently did not pay a dividend during the fourth quarter of 1998, just prior to its merger with Astoria. PX 423, Ex. D (Expert Report of Charles W. Calomiris (June 14, 2004)).

and Astoria Financial Corporation, pursuant to which each share of the former would be exchanged for 1.15 shares of the latter. PX 406 at VLI004 0549-0550 (Astoria Financial Corp.'s 14(a) definitive proxy statement (July 17, 1998)). The transaction was consummated on September 30, 1998, with Long Island and Long Island Bancorp merging into Astoria Federal Savings and Loan Association and Astoria Financial Corp., respectively. Tr. 612:25 to 613:10 (Test. of Fuster). For each share of Long Island's common stock, Long Island's shareholders received Astoria shares valued at $48.44, for a capital gain of 321%, or 38% on an annualized basis, over the IPO price of $11.50 per share. PX 423 at 12 (Report of Charles W. Calomiris (June 14, 2004)).

ANALYSIS

A. Liability

The disputed issue respecting the government's liability for breach of contract focuses on interpretation of contractual language. The government has conceded that it entered into a contract with Syosset, Hr'g Tr. 29:6-15, 34:1-15 (closing arguments on July 7, 2005). Long Island maintains that the contractual documents and circumstantial evidence demonstrate that both Syosset and Centereach entered into a contract with the government that includes, among other terms, the right of the banks to count supervisory goodwill toward regulatory capital and to amortize that goodwill over a period of forty years. Hr'g Tr. 15:19 to 19:7 (closing arguments on July 7, 2005); Plaintiffs' Post-Trial Brief ("Pls.' Br.") at 31-36; Plaintiffs' Post-Trial Reply Brief ("Pls.' Reply") at 4-8. The government denies that its contract includes the right of either Syosset or Centereach to amortize

goodwill over a particular period of time, Hr'g Tr. 31:17 to 32:8, 33:5-8; Defendant's Post-Trial Responsive Brief ("Def.'s Reply") at 4-5, and it also denies that the contract obligates the United States to render performance to Centereach. Tr. 31:22 to 32:14 (opening arguments); Defendant's Post-Trial Brief ("Def.'s Br.") at 29-36; Def.'s Reply at 2-4.

1. *Amortization of goodwill over a forty-year period.*

The documents involved in Syosset's FSLIC-assisted purchase transaction contain some ambiguity, but the circumstances surrounding the transaction manifest that the parties intended to enshrine an amortization period of forty years and that they did so in a unique and awkward but effective way. Except for Syosset's offer letter for the acquisition of Suffolk Phoenix, PX 4 at 3 (quoted in pertinent part supra, at 620), the contractual documents do not specify an amortization period of forty years. Rather, they refer generally to pre-FAS 72 accounting principles, push-down accounting, and Bank Board Memorandum R-55. Section 10 of the Assistance Agreement provides in pertinent part:

> Except as otherwise provided in this Agreement, any computations made for the purposes of this Agreement shall be governed by generally accepted accounting principles as applied in the savings and loan industry, including the accounting principles in effect for mergers and acquisitions prior to the issuance of FASB # 72, permitting the use of "push down accounting" as noted in R Memorandum # 55 and those accounting principles used by [Syosset] prior to this Agreement ....

PX 1 § 10 (executed Assistance Agreement (Aug. 17, 1983)).

Putting aside briefly the reference to pre-FAS 72 accounting principles, the reference in Section 10 of the Assistance Agreement to "push down accounting" and Bank Board Memorandum R-55 by themselves provide an answer to the liability question. Section 17 of the Assistance Agreement, the integration clause, states in part that "[t]his Agreement and the Master Agreement, together with any interpretation or understanding agreed to in writing by the parties, constitute the entire agreement between the parties." *Id.* § 17. The "entire agreement" included Bank Board Resolution No. 83-435, which provided:

> That not later than 90 days following the effective date of the acquisition of Centereach by [Syosset], [Syosset] and Centereach shall submit to the Supervisory Agent an opinion of independent certified public accountants that [Syosset] and Centereach have accounted for the transaction in accordance with generally accepted accounting principles, except that as herein provided by the Bank Board, for purposes of reporting to the Bank Board: (a) "push down" accounting shall be used to reflect the acquisition on Centereach's books; and (b) the cash contribution by the FSLIC to Centereach with respect to Suffolk [Phoenix] pursuant to the Assistance Agreement shall be deemed a contribution to net worth, and shall be booked as a direct credit to Centereach's net worth.

PX 2 at 11 (FHLBB Resolution No. 83-435 (Aug. 11, 1983)). In addition, Syosset and Centereach each

entered into a Master Agreement with the government, which agreement required the respective bank to

> keep proper and adequate books of record and account, in which full and substantially correct entries shall be made of all dealings and transactions relating to the Certificates and the properties, business and affairs of the [bank], and such books and records shall be adequate to enable the [bank] to prepare its financial statements in accordance with generally accepted accounting principles consistently applied and in accordance with § 10 of the Assistance Agreement.

PX 104 at LIP0000210 (Section 5.5 of Centereach's Amendment to Master Agreement, Income Capital Certificates and Purchase Agreement (Aug. 17, 1983)), LIP0000495 (Section 5.5 of Syosset's Master Agreement for Issuance of Income Capital Certificates (Aug. 17, 1983)).

These documents and much of the circumstantial evidence in this case bear some similarity to the evidence involved in the Century and Ohio transactions in *Home Savings of America, F.S.B.* v. *United States*, 57 Fed. Cl. 694 (2003) ("*Home Savings III*"), *aff'd in part and vacated and remanded in part*, 399 F.3d 1341 (2005) ("*Home Savings IV*"). In that case, "[t]he Century and Ohio Resolutions did not specify an amortization period, but they did set out the process by which the amortization period would be determined." *Home Savings IV*, 399 F.3d at 1350 (citing *Home Savings III*, 57 Fed. Cl. at 704 ("Home Savings was to provide regulators with an analysis, supported by independent auditors, [that] included the proposed amortization period for supervisory

goodwill arising from those transactions."). *Cf. Fifth Third Bank of W. Ohio* v. *United States*, 402 F.3d 1221, 1232 (Fed. Cir. 2005) ("The need to specify the exact length of the amortization period never became a relevant consideration; it got resolved by default in the later paperwork."). In the instant case, the Resolution refers to push-down accounting, and both Master Agreements incorporate the accounting treatment specified in Section 10 of the Assistance Agreement, which section in turn incorporates Memorandum R-55. PX 2 at 11; PX 104 at LIP0000210, LIP0000495. The Resolution thus refers implicitly to Memorandum R-55 (which established the push-down method of accounting, see supra, at 620 n. 6), and the Master Agreements explicitly incorporate that document. Memorandum R-55 sets out that process, and thus the transactional documents "set out the process by which the amortization period [was to] be determined." *Home Savings IV*, 399 F.3d at 1350.

Memorandum R-55 describes "[p]ush-down accounting [a]s the establishment of a new accounting and reporting basis" and states that such method "is acceptable for purposes of reporting to the FHLBB although its use is not required." PX 8 at 1 (Memorandum R-55 (Jan. 17, 1983)) (emphasis added). The memorandum describes the reporting process as follows:

> Supervisory staff encountering the use of push-down accounting should determine if it has been applied in accordance with GAAP. An opinion from an independent public accountant that both the establishment of a new basis of accounting at the time of the acquisition and the current use of push-down

> accounting are in conformity with GAAP, or, alternatively, an independent certified public accountant's opinion on the association's subsequent financial statements which is not qualified with respect to the use of push-down accounting should provide evidence to support this staff determination. This requirement may be satisfied at the date of completion of the regular audit covering the period during which the accounting change was made.

Id. at 2. Importantly, Memorandum R-55 further sets out the process for determining the period of amortization in the following way:

> In addition to assuring that an opinion as to the appropriateness of the push-down accounting applied has been rendered by the independent public accountant, sufficient specific review should be made to assure that:
>
> ....
>
> 2. amounts of intangible assets, including goodwill, are reasonably determined and the amortization methods and periods are justified, but, in any event, do not exceed 40 years from the date of the acquisition; ....

Id.

Syosset and Centereach complied with the reporting process for amortization periods set out in Memorandum R-55. Syosset's and Centereach's accountant, Peat Marwick, reviewed the accounting for Syosset's acquisition of Centereach, and in November 1983, the chairman of Peat Marwick sent

Syosset and Centereach a letter opining that the transaction was accounted for in accordance with GAAP and "that push down accounting can be reflected on the books and records of Centereach." PX 9 at LIP0140600 (Letter from Peat Marwick to Conway (Nov. 15, 1983)). The banks submitted that accountant's opinion to the supervisory agent of the Bank Board, explaining that they were acting pursuant to the Bank Board's Resolution No. 83-435. *Id.* at LIP0140599 (Letter from Nacos to Vigna (Nov. 17, 1983)). Neither Peat Marwick's opinion nor the banks' letter to the Bank Board attaching that opinion specified a particular length of amortization. However, Peat Marwick also examined the banks' consolidated statements of financial condition as of September 30, 1983 and 1982, and sent them its accountants' report in December 1983. PX 117 at GTP0096971 (Letter from Peat Marwick to Syosset's board of directors (Dec. 9, 1983)). In that report, Peat Marwick stated explicitly that "[t]he excess of cost over the net assets acquired totaled approximately $625,375,000 and is being amortized on the straight-line basis over 40 years." *Id.* at GTP0096985. In May 1984, the banks submitted to FSLIC that accountants' report along with its consolidated statements of financial condition as of September 30, 1983 and 1982, explaining that it was doing so in accord with the Master Agreement. PX 118 (Letter from Nacos to David K. Schweitzer, Case Manager, Financial Assistance Division, FSLIC (May 29, 1984)). The materials submitted also included Mr. Fuster's certification of the financial statements, which he confirmed "are in accordance with generally accepted accounting principles, consistently applied and in accordance with Section 10 of the Assistance Agreement." PX 117 (Letter

from Fuster to FSLIC (May 29, 1984)). The preparation of Peat Marwick's opinion on the banks' financial statements complied with the reporting requirement of Memorandum R-55, which "may be satisfied at the date of completion of the regular audit covering the period during which the accounting change was made." PX 8 at 2 (Memorandum R-55 (Jan. 17, 1983)) (paragraph quoted in full supra, at 634). The regulators notified the banks that they received Peat Marwick's audit report. PX 119 (Letter from Vincent A. Cerreta, Assistant District Director, Operations, Office of Examinations & Supervision, FHLBB, to Conway (June 4, 1984)). Thus, a forty-year amortization period for the goodwill was enshrined.

The peculiar, unique aspect of Suffolk's contract for the acquisition of Centereach relates to the backhanded way in which the parties established accounting treatment that allowed forty-year amortization of goodwill. The testimony at trial of the participants in the negotiations supports the banks' interpretation of the contract and does nothing to further the government's position in litigation of this case. Mr. Fuster, the lead negotiator for Syosset, testified that he edited an early draft of the Assistance Agreement prepared by the government's counsel, to include specific references to pre-SFAS 72 accounting as well as to push-down accounting and Memorandum R-55, because he intended to contract for the banks' ability to count goodwill as regulatory capital and to amortize that goodwill over forty years, as specified in Syosset's amended bid letter. Tr. 124:25 to 133:12 (Test. of Fuster); PX 4 at 3 (Letter from Hall to Beesley (Apr. 5, 1983)). Mr. Fuster's understanding was that the phrase he inserted into the draft Assistance

Agreement referring to pre-SFAS 72 accounting was sufficient to specify an amortization period of forty years. Tr. 133:7-12 (Test. of Fuster). In this regard, he proposed these changes after Long Island's counsel received from the Bank Board a response to Syosset's amended bid letter, which response proposed a thirty-five year amortization schedule and use of regulatory accounting principles, rather than accounting under generally accepted accounting principles. Tr. 117:3 to 118:11 (Test. of Fuster); Tr. 818:4-19 (Test. of Hall); PX 6 at 6 (Letter from Hayes to Hall (undated)). Mr. Hall, Syosset's outside counsel who participated in the negotiations, including the meeting held at the Bank Board's offices in July 1983, testified that the Bank Board's chief accountant, Robert Moore, nodded in acquiescence to these terms. Tr. 820:4 to 822:3 (Test. of Hall). The revisions proposed by Mr. Fuster thereafter were put in place and used in the final text of the Assistance Agreement.

The witnesses the government presented at trial regarding contractual interpretation supported the banks' position. In particular, Mr. Vigna, the District Director of OTS at the pertinent time, testified that at the time of his deposition in this case in 1999, he apparently understood that the parties contracted for an amortization term of forty years. Tr. 4463:11 to 4464:17 (Test. of Vigna).

The evidence thus demonstrates that the banks established through the contractual negotiations that they wanted agreement on use of a forty-year schedule for amortizing goodwill, that the government agreed, and that the contractual language reflected that agreement, albeit in a unique way. The parties' subsequent conduct is fully

consonant with this finding. Subsequent to its initial consolidated financial statements and accountants' report in 1983, the banks continued submitting such materials for each of the years 1984 through 1989, in which materials the Bank consistently and continuously specified that it was amortizing goodwill over forty years. PX 125 at LIP0208091 (the banks' Consolidated Financial Statements (1984 & 1983)); PX 130 at GTP0026505 (the banks' Consolidated Financial Statements (1985 & 1984)); PX 141 at LIP197040 (the banks' Consolidated Financial Statements (1986 & 1985)); PX 145 at LIP0148359 (the banks' Consolidated Financial Statements (1987 & 1986)); PX 152 at GTP0085312 (the banks' Consolidated Financial Statements (1988 & 1987)); PX 180 at LIP0017422 (the banks' Consolidated Financial Statements (1989 & 1988)). Moreover, FDIC and OTS conducted regular examinations of the banks subsequent to the acquisition and issued reports expressing their understanding that "[i]n accordance with a FSLIC Assistance Agreement, the goodwill was to be amortized over a forty-year period, with LISB-Centereach permitted to include the outstanding goodwill as part of capital for all regulatory purposes." DX 775 at WOQ638 0108 (OTS's report of examination of the banks (commenced Apr. 8, 1991)); PX 262 at 13 (OTS's report of examination of the banks (commenced Sept. 1, 1992)); accord DX 768 at 1 (FDIC's report of examination of Centereach (Dec. 11, 1990)); PX 227 at 8 (OTS's report of examination of Centereach (commenced Apr. 8, 1991)); DX 779 at 1 (FDIC's report of examination of Centereach (July 27, 1992)); see also PX 138 at 8 ("S Memo" from O'Connell to Jeff Sconyers; Secretary to FHLBB (Apr. 16, 1986)). At no point did the regulators object

to Centereach's inclusion of its goodwill in its regulatory capital or to the amortization of that goodwill over forty years. Tr. 269:24 to 270:5, 274:6-13 (Test. of Fuster). As the trial court and the court of appeals observed in Home Savings with respect to similar circumstantial evidence, "it is unreasonable to believe that regulators would have allowed [plaintiff] to amortize supervisory goodwill over a 40 year period absent an understanding that this was the implementation of the process agreed upon in the ... Assistance Agreements." *Home Savings IV*, 399 F.3d at 1351 (quoting *Home Savings III*, 57 Fed. Cl. at 705).

2. *Promises running to Centereach as well as Syosset.*

Secondarily, the government argues "[t]he plain language of the Assistance Agreement ... demonstrates that Centereach did not have a goodwill promise." Def.'s Br. at 29. In developing this argument, the government focuses solely on the Assistance Agreement and ignores the other two primary components of the contract, the Resolution and the Master Agreements. In particular, the government observes that the term "this Agreement" in the Assistance Agreement refers only to the Assistance Agreement, to the exclusion of the "entire agreement," such that the phrase "computations made for the purpose of this Agreement" in Section 10 of the Assistance Agreement refers only to computations required by the Assistance Agreement itself. *Id.* at 30-32; Def.'s Reply at 2. The government then notes that the only computation so required is that addressed by Section 9, providing that "[Syosset] shall cause the net worth of CENTEREACH to be maintained at" one percent for

the first ten years following consummation of the transaction. Def.'s Br. at 32-34 (quoting PX 1 § 9 (executed Assistance Agreement (Aug. 17, 1983))); Def.'s Reply at 3. From these premises, the government contends that "[t]hese computations included Syosset's obligation to maintain Centereach's capital, but not any computations allowing Centereach to include goodwill in its capital." Def.'s Br. at 35; see also Tr. 32:12-14 (defendant's counsel at opening arguments stating that "[t]here is no provision in the [A]ssistance [A]greement that addresses Centereach's obligation itself to meet prevailing capital requirements").

The government misconstrues the pertinent terms of the Resolution and Master Agreements and ignores their relationship to Memorandum R-55 and to Section 10 of the Assistance Agreement. The Resolution specifically obligates both Syosset and Centereach to submit to the Supervisory Agent an accountant's opinion that both banks have accounted for the transaction in accordance with GAAP, including the application of push-down accounting "to reflect the acquisition on Centereach's books." PX 2 at 11 (FHLBB Resolution No. 83-435 (Aug. 11, 1983)) (provision quoted in full supra, at 633). That provision of the Resolution is not surprising, considering that Centereach, as the subsidiary entity, was necessarily and inherently involved in a purchase transaction applying push-down accounting. The goodwill was recorded on Centereach's books and records, not those of Syosset. See PX 8 (Memorandum R-55 (Jan. 17, 1983)). The government seeks to negate the import of the Resolution by asserting that "[t]he resolution imposed an independent obligation upon Syosset and Centereach to provide an accountant's opinion" and

that "[c]onspicuously lacking in the resolution were any provisions specifically providing that, for purposes of Centereach's regulatory reporting requirement, pre-SFAS No. 72 accounting would apply, a particular amortization period could be used, or goodwill would count fully as an asset." Def.'s Br. at 31-32 (emphasis added); see also Def.'s Reply at 5. However, far from imposing an "independent" requirement on the banks, the Resolution's use of the term "push-down accounting" for purposes of recording the goodwill on Centereach's books refers to Memorandum R-55, which sets forth precisely the provisions the government finds "[c]onspicuously lacking" in the four corners of the Resolution itself. See *supra*, at 634.

Moreover, the Master Agreements for both Syosset and Centereach require each bank "to prepare its financial statements in accordance with [GAAP] principles consistently applied and in accordance with § 10 of the Assistance Agreement." PX 104 at LIP0000210 (Section 5.5 of Centereach's Amendment to Master Agreement, Income Capital Certificates and Purchase Agreement (Aug. 17, 1983)), LIP0000495 (Section 5.5 of Syosset's Master Agreement for Issuance of Income Capital Certificates (Aug. 17, 1983)) (provision quoted in full *supra*, at 634). The government counters the natural thrust of this provision in the Master Agreements by contending that "[t]his [provision] simply means that GAAP applies, except to the extent section 10 applies different treatment to calculations that are required pursuant to the Assistance Agreement." Def.'s Reply at 2. This purported interpretation of the Master Agreements is disingenuous; Section 10 of the Assistance Agreement provides for GAAP accounting

as it existed prior to SFAS 72 and specifically for the accounting treatment described in Memorandum R-55. See *supra*, at 633-35.

In short, the contract Syosset and Centereach entered into with the government includes Centereach's right to count its supervisory goodwill toward regulatory capital and to amortize that goodwill over a forty-year period. With the enactment of FIRREA and the adoption of regulations implementing that statute, the government breached this contract. That breach caused damages and loss to Centereach and Syosset, as the facts and circumstances proven at trial establish, and the government is liable for those damages and losses.

B. *Damages*

Compensation by way of an award of money damages to the injured party is the primary means of remedying a breach of contract. 24 Samuel Williston & Richard A. Lord, *A Treatise on the Law of Contracts* § 64:1, at 4-5 (4th ed. 2002) (hereafter "*Williston*"). Expectancy damages, the amount representing the benefit to the non-breaching party had performance been rendered, ordinarily provides the basis for an award of contractual damages. *LaSalle Talman Bank, F.S.B.* v. *United States*, 317 F.3d 1363, 1371 (Fed. Cir. 2003); *Restatement (Second) of Contracts* § 344 & cmt. a (1981); *Williston* § 64:2, at 30. A plaintiff is entitled to an award of expectancy damages upon showing by a preponderance of the evidence that such damages were proximately caused by the breach, that they were actually foreseen or reasonably foreseeable, and that the amount can be estimated with reasonable

certainty. *La Van* v. *United States*, 382 F.3d 1340, 1351 (Fed. Cir. 2004).

Expectancy damages are often measured by the amount of profits lost but also include any other losses caused by the breach, including incidental losses. *Glendale Fed. Bank, FSB* v. *United States*, 239 F.3d 1374, 1380 (Fed. Cir. 2001) (citing *Restatement (Second) Contracts* § 347); *Williston* § 64:2, at 30. "Incidental losses include costs incurred in a reasonable effort, whether successful or not, to avoid loss, as where a party pays brokerage fees in arranging or attempting to arrange a substitute transaction." *Restatement (Second) Contracts* § 347 cmt. c; see also *Williston* § 66:55-56, at 664-677.

1. *Cost of replacement capital.*

a. *Causation.*

The banks have demonstrated that their efforts toward replacing Centereach's supervisory goodwill with tangible capital "w[ere] a direct consequence of the breach." *LaSalle Talman*, 317 F.3d at 1373-74. As the Federal Circuit noted in *LaSalle Talman*, "precedent distinguishes between remote consequences of contract breach, whether favorable or unfavorable to the non-breaching party, and those that are directly related to or direct consequences of the breach.... [R]eduction of loss through a substitute transaction is generally a direct mitigation of damages." *Id.* at 1373. Consequences of the breach that are unfavorable to the injured party are recoverable as damages, whereas any favorable consequences must be credited against damages, see, *e.g.*, *LaSalle Talman*, 317 F.3d at 1375, provided that the causal connection between the breach and such consequences has been "definitely established."

California Fed. Bank v. *United States*, 395 F.3d 1263, 1268 (Fed. Cir. 2005) (internal quotation and citations omitted).

The banks sought to mitigate the loss due to the breach, *i.e.*, the loss of regulatory capital in the form of amortizable goodwill, by a three-step approach, all three steps of which were "directly related to or direct consequences of the breach." *LaSalle Talman*, 317 F.3d at 1373. First, because upon enactment of FIRREA Centereach immediately failed the minimum capital requirements imposed by FIRREA, Centereach was required to submit to OTS a capital plan demonstrating how it would meet those requirements by December 31, 1994, as specified in OTS's Thrift Bulletin 36. DX 292 at LIP134539 (Letter from Vigna to Centereach's board of directors and managing officer attaching copies of Thrift Bulletins 36 and 36-1 (Dec. 18, 1989)). Pursuant to Centereach's capital plan filed in October 1990, Syosset made capital contributions to Centereach through 1994. PX 13 at 32-34 (Capital Plan for Centereach (Oct. 25, 1990)). Those direct capital contributions amounted to approximately $9 million. PX 13 at 31 (Syosset to make direct capital contributions to Centereach of $2 million per year during the capital-plan period). However, in a departure from the regimen contemplated by Thrift Bulletin 36, the capital plan stated that Centereach would "determine later the precise further actions to be taken in 1994 (or thereafter), depending on the economic, regulatory, legal and other circumstances at the time." *Id.* at 42. The capital plan for Centereach thus did not lay out a specific path or paths to attaining capital compliance. OTS's approval of the capital plan in such circumstances was highly unusual, if not unique. As James Caton,

the Deputy Assistant Director of Special Supervision of OTS who reviewed Centereach's capital plan, testified, Centereach was "one of the very few, if not the only, thrift which did not project capital compliance by the end of 1994." Tr. 3296:15-17 (Test. of Caton); see also Tr. 3289:22 to 3291:3 (Test. of Caton). Mr. Caton explained that OTS made an exception for Centereach because among other reasons, "[t]he current management team was very strong. They were sterling, and we had a lot of confidence in them." Tr. 3314:6-7 (Test. of Caton); accord 3291:4-22 (Test. of Caton); see also Tr. 3288:23 to 3289:4 (Test. of Caton). The banks consistently were making money and retaining earnings during the capital-plan period, and they ultimately used all of those retained earnings to reduce Centereach's capital deficit.

The banks' second step in mitigation of the government's breach was their restructuring plan. The banks had strongly resisted consolidation, DX 317 (Internal mem. from Ruth Ann Popielarski to the files (May 1, 1990)); PX 208 (Letter from Viklund to Vigna supplementing meeting held on April 27, 1990 (May 1, 1990)); PX 11 (Internal mem. from Kehoe to the files (May 8, 1990)), and OTS had backed away from requiring the banks to merge in 1990, see *supra* at 624, but the banks eventually adopted a restructuring plan that projected achievement of minimal capital adequacy by way of a sale of assets, branches, and deposits, followed by a merger and write-off of goodwill. PX 14 at GTP0057159, GTP0057162-63 (Bear Stearns's presentation on restructuring alternatives (Nov. 19, 1992)); PX 283 at LIP0119463-64; LIP0119469 (Minutes of Centereach's board of directors meeting (Nov. 19, 1992)); DX 1657 (Letter from Viklund to Vigna (Nov.

23, 1992)). The restructuring plan was approved by OTS, see *supra*, at 626, and implementation of this restructuring plan produced favorable results. In effect, the restructuring plan reduced the size of the banks by approximately $1.0 billion and correspondingly reduced the amount of tangible capital the banks had to have. With the merger, Syosset used its retained earnings to fill Centereach's capital deficit. As a consequence, Centereach was released from its capital plan. PX 332 (Letter from Vigna to Long Island's board of directors (Sept. 3, 1993)). However, the banks' actions in mitigation thus far had resulted in minimal capital compliance on a consolidated basis. Tr. 369:6-12 (Test. of Fuster); PX 520 (Demonstrative showing tangible capital ratios before and after restructuring). Additionally, as FDIC opined, the restructuring plan resulted in the unfavorable consequence that "the Bank had to sell some high earning and good assets," PX 16 at 9 (Long Island's board of trustees meeting (Oct. 26, 1993)), causing FDIC to rate the merged Bank as a "3" on the MACRO scale, putting its capitalization category in jeopardy for the future. PX 15 at GTP0056285 (FDIC's report of examination of Long Island (commenced July 6, 1993)); see also PX 16 at 9. The Bank sought to address its higher proportion of nonperforming and underperforming assets by way of the Bulk Sale and sale of real estate owned. PX 391 at GTP0083019 (Long Island Bancorp's annual report (1994)).

Long Island's third and final mitigating substitute transaction was its conversion and issuance of stock through a "community" initial offering, through which it succeeded in raising from its depositors tangible capital sufficient to replace

the remainder of the lost goodwill and to restore the regulatory capital position to the level it had been before FIRREA, albeit with a 20% smaller bank. See *supra*, at 630-31. The Bank's conversion was directly related to restoring its capital cushion, the loss of which was a direct consequence of the government's breach.

The government contests the second and third of the three mitigating steps. Presumably, it did not contest the bank's actions under the first mitigating step, the capital-plan period, because the banks sought no damages respecting that step. With respect to the bank's second step of mitigation, the restructuring plan, the government argues that the sale of branches and deposits was "not caused by the breach, but, rather, w[as] the product of an independent business decision, ... [viz.,] to position [the Bank] to convert." Def.'s Br. at 40. In this regard, the government hypothesizes that Centereach "could have been relieved of the restriction of the Capital Plan and met all of the capital requirements of both FIRREA and FDICIA by merely consolidating ... as early as January 1993" without shrinking. *Id.* As the court of appeals and this court have observed in similar circumstances, "[t]he clear import of the government characterizing its argument as one of causation is to avoid the reasonability element of the mitigation doctrine," *First Heights Bank, FSB* v. *United States*, 422 F.3d 1311, 1317, 2005 WL 1962989, at *4 (Fed. Cir. 2005); see also *Cuyahoga Metro. Hous. Auth.* v. *United States*, 65 Fed. Cl. 534, 544-45 & n. 14 (2005) (discussing *Franconia Assocs.* v. *United States*, 61 Fed. Cl. 718, 750 (2004), and citing *Globe Sav. Bank, F.S.B.* v. *United States*, 65 Fed. Cl. 330, 347-49 (2005), and *Long Island Sav. Bank, FSB* v. *United*

States, 60 Fed. Cl. 80, 90 (2004)), because the breaching party bears the burden of proving that the actions taken by the injured party are unreasonable, whereas the injured party has the burden of proving causation. *Globe Sav.*, 65 Fed. Cl. at 348; see also *First Heights*, 422 F.3d at 1316, 2005 WL 1962989, at *4.[19]

The government's position is grounded on the premise that because Syosset and Centereach in practice operated in tandem, the court should treat them on a consolidated basis. See Def.'s Br. at 40. In this regard, defendant argues that the banks would have been in capital compliance on a consolidated basis prior to the branch sale, and thus that the banks' reason for entering that transaction could not have been caused by their desire to achieve compliance. *Id.* The government's argument assumes too much. As in other recent cases in this court, "[t]here were no grounds offered here to 'pierce' the corporate veil on the theory that [the subsidiary] is not an independent entity." *LaSalle Talman Bank, F.S.B.* v. *United States*, 64 Fed. Cl. 90, 114 (2005). Furthermore, the contemporaneous evidence demonstrates that the regulators did not treat the banks on a consolidated basis for purposes of capital compliance. For example, OTS warned Centereach three days after the prompt-corrective-action provision of FDICIA took effect that Centereach was "critically undercapitalized." PX 293 (Letter from Vigna to Centereach's board of directors (Dec. 22, 1992)). Moreover, the government is wrong that the banks could have achieved capital compliance

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[19] The government's arguments questioning the reasonableness of the banks' efforts to mitigate the breach are addressed in detail *infra*, at 642-44.

without selling branches and about $1 billion in deposits. In developing the restructuring plan, the banks' advisor, Bear Stearns, had analyzed the option of selling assets to realize a gain sufficient to allow the banks to avoid branch sales. DX 926 at 9 (Presentation by Bear Stearns to the banks' Special Committee (Sept. 29, 1992)). They had concluded that the banks would have to sell $3.7 billion in assets, *id.*, that the banks would achieve a 3.99% tangible-capital ratio, *id.* at PLI169 1581, but that the banks would immediately begin to show significant and recurring operating losses because they would have sold off virtually all of their higher earning assets. See *supra*, at 627, and *infra* at 642.

The government further presses this point by referring to Bear Stearns's presentation to the banks' board given in September 1992, and asserting that the "entire thrust ... was the potential conversion of [Long Island] to a stock institution." Def.'s Br. at 40 n.10. The government is correct only insofar as Bear Stearns's presentation identified "the potential for conversion to stock form" as one of several "restructuring/recapitalization alternatives." DX 926 at 13. It otherwise is wrong. OTS, not Long Island, was requesting that consideration of a conversion plan occur at an appropriate time. As Mr. Caton of OTS testified, one of the reasons OTS rejected Centereach's initial capital plan was that the plan "seemed to have ruled ... out for the time being" a "mutual[-]stock conversion" as a potential restructuring alternative. Tr. 3296:5 to 3297:21 (Test. of Caton). Mr. Caton further explained that "in OTS's view, we thought that the conversion of Long Island Savings Bank from mutual to stock ownership was a viable alternative, which should be continually explored by management." Tr. 3312:22-25 (Test. of

Caton). Consequently, prior to approving the second capital plan Centereach submitted, Mr. Caton and other OTS regulators, "[u]pon further discussions with Centereach, ... were able to work out some modifications to the early capital plan," including "[i]nfusions from Syosset into Centereach, capital infusions, as well as management's commitment and promise to continually explore capital-raising strategies, such as conversion[;] mutual [-]stock conversion was the primary one." Tr. 3304:15-22 (Test. of Caton).

The evidence presented at trial demonstrates that the banks designed their restructuring plan to address their capital deficiency in 1992 and 1993, not to prepare for a public offering. Mr. Singer, for example, explained that at the time the banks' Restructuring Committee was creating its plan, "[w]e had no desire to go public. Our desire was to solve our capital problem and grow the company and manage it, as we had managed it for a number of years." Tr. 1355:15-17 (Test. of Singer); accord Tr. 1355:18 to 1357:5 (Test. of Singer). Messrs. Viklund and Conefry further elaborated that the board was not considering a public offering in the Fall of 1992, because the merged entity would have been only minimally capital compliant and its stock would not have been marketable. Tr. 1079:25 to 1082:11, 1215:24 to 1218:13 (Test. of Viklund); Tr. 1435:14 to 1436:10 (Test. of Conefry). The testimony of these witnesses is confirmed by the minutes of the Restructuring Committee's meeting on August 24, 1992, at which the Committee deliberated over which investment banking firm to select for advice on restructuring alternatives. Among the reasons the Committee declined to select Sandler O'Neil was that "[t]hey focused more on going with a public offering

than a restructuring as we proposed it." PX 260 at 4 (Minutes of Restructuring Committee's meeting (Aug. 24, 1992)).

Regarding the Bank's third step of mitigation, the conversion and IPO, the government contends that Long Island would have converted at about the same time regardless of the breach. Def.'s Br. at 53-54; Def.'s Reply at 6-7.[20] Defendant additionally argues that the Bank converted in the "breach world" for independent business reasons, including a desire to compete with thrifts having higher levels of tangible capital. Def.'s Br. at 54-56. In contending that proximate causation cannot be established in

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[20] Defendant also erroneously asserts that Long Island "acknowledges" that Syosset would have contributed its retained earnings to Centereach at around the same time regardless of the breach. Def.'s Reply at 7. The government cites to testimony of Dr. Baxter, one of plaintiffs' experts, for support for this proposition. See *id.* (citing Tr. 2552:11-19 (Test. of Baxter)). However, that testimony relates only to conversion, not to use of retained earnings. See Tr. 2552:11-19 (Test. of Baxter).

As to conversion, Dr. Baxter testified that "had there been no breach, a conversion would have taken place at approximately the same time." Tr. 2359:1-3 (Test. of Baxter). This testimony seems to have been based upon Dr. Baxter's assessment of when the capital markets might have been receptive to an IPO for a thrift rather than an evaluation of the banks's particular circumstances. In this vein, Dr. Baxter testified that he did not believe the banks could have attained capital compliance absent the restructuring, see Tr. 2359:21 to 2361:5 (Test. of Baxter), and he also testified that the level of tangible capital achieved by the banks as a consequence of the restructuring, including the merger, was in the view of the banks' management insufficient for operation with comfort. Tr. 2473:2 to 2476:25 (Test. of Baxter). In all events, Dr. Baxter had no first-hand knowledge of the banks' plans and actions.

these circumstances, the government is really arguing yet again that Long Island's mitigation was unreasonable. It, not Long Island, has the burden of that demonstration, and the government has not satisfied that burden. It simply would not have been possible for the Bank to have operated in the Long Island area at a minimal level of capital compliance. Some cushion was necessary for any bank to operate in that marketplace, and the cushion Long Island eventually achieved was entirely reasonable. See *infra*, at 643-44.[21] In short Long Island has established causation. It's efforts in raising capital through a conversion and community offering of stock to replace its lost goodwill and rebuild its pre-FIRREA capital cushion was a direct action in mitigation of the breach.

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[21] Moreover, as the Federal Circuit has explained, the causal connection between the breach and damages must be "definitely established" but that "is not to say that the breach must be the sole factor or sole cause [of the damages]. The existence of other factors operating in confluence with the breach will not necessarily preclude recovery based on the breach." *California Fed.*, 395 F.3d at 1268. Before the breach, the board operated the banks at a capital cushion near 8% for business reasons, and the board desired to operate Long Island at the same level. See *supra*, at 623, 630-31. Here, as in *Home Savings III*,

> [t]he evidence is clear that, had FIRREA not disallowed the use of supervisory goodwill, [plaintiff] would have raised less capital, in the amount of that disallowed supervisory goodwill. The cost of raising that capital is thus a direct result of the government's breach.
>
> There is nothing remote or consequential about these damages. Plaintiffs have isolated costs related only to the capital raised to replace supervisory goodwill. That [plaintiff] had other reasons to raise capital is immaterial.

57 Fed. Cl. at 727 (citations omitted).

b. *Forseeability.*

The banks have also proven that the damages they incurred in connection with raising replacement capital were foreseeable. The government responds that the third stage of Long Island's mitigation, its conversion, was not foreseeable because Centereach's capital plan allowed it "to achieve capital compliance through normal operations." Def.'s Br. at 60. Defendant again ignores that it bears the burden of proof that Long Island's mitigation was unreasonable, as well as the importance to Long Island of a capital cushion. The court of appeals in *Home Savings IV* explained that

> the regulators undoubtedly would have understood that when they promised to allow supervisory goodwill that taking away this inducement would cause [plaintiff] to "re-evaluate [its] capital ratio[ ]" and "take on replacement capital." *Home III*, 57 Fed. Cl. at 726. As the government's regulators were aware of [plaintiff's] practice of maintaining a conservative capitalization ratio, the government in this case should have expected [plaintiff] to seek to restore that ratio after the passage of FIRREA.

399 F.3d at 1355. In the instant case too, it was foreseeable that Long Island would raise tangible capital to restore its capital position.

c. *Mitigation.*

A party injured by a breach of contract has a duty to mitigate damages. As the Restatement (Second) Contracts provides, "damages are not recoverable for loss that the injured party could have avoided without undue risk, burden or humiliation."

Restatement (Second) Contracts § 350(1). In other words, " 'a party cannot recover damages for loss that he could have avoided by reasonable efforts.'" *Indiana Michigan Power Co.* v. *United States*, 422 F.3d 1369, 1375, 2005 WL 2173563, at *4 (Fed. Cir. 2005) (quoting *Robinson* v. *United States*, 305 F.3d 1330, 1333 (Fed. Cir. 2002), and *Restatement (Second) Contracts* § 350 cmt. b). See also *Tennessee Valley Auth.* v. *United States*, 60 Fed. Cl. 665, 674 (2004) ("When it became obvious to [plaintiff] that [the government] would not perform under the contract, [plaintiff] was justified, indeed obligated, to take steps to minimize its losses in light of [the government's] imminent non-performance.").

It is the breaching party's burden to prove that the injured party's actual actions taken in mitigation were unreasonable. *Globe Sav.*, 65 Fed. Cl. at 348 (citations omitted). See also *First Heights*, 422 F.3d at 1316-17, 2005 WL 1962989, at *4. The banks' mitigation during the capital-plan period prior to the restructuring is not relevant to this contention because the banks did not seek damages for their replacement of Centereach's goodwill via Syosset's capital contributions to Centereach at that time or to Centereach's retention of earnings during that period. However, the government challenges the banks' actions in mitigation during the restructuring and the conversion as being unreasonable even though the actions proved to be successful.

The contemporaneous evidence presented at trial proves that the restructuring plan was a reasonable step in mitigating the loss of goodwill as regulatory capital. As noted *supra*, at 640, the government does not contest that the banks needed to sell assets as part of the restructuring. Rather, the government

focuses on the banks' sale of branches and deposits. In developing a restructuring plan for Centereach, Messrs. Fuster and Singer considered merging the banks without shrinking them first, but they rejected that alternative because it was unreasonable to consume Syosset's capital in that effort when the resulting bank would still be undercapitalized. Tr. 344:25 to 345:8 (Test. of Fuster). This decision was confirmed by Bear Stearns's restructuring analysis and presentations. As Bear Stearns's September 1992 presentation to the banks' Special Committee explained, "deposits must be sold to reach targeted capital levels." DX 926 at 13 (presentation by Bear Stearns to the banks' Special Committee (Sept. 29, 1992)). Similarly, in another presentation on restructuring alternatives two months later, Bear Stearns told the board that the bank would be "significantly undercapitalized" absent a sale of branches. PX 14 at GTP0057159 (Presentation on restructuring alternatives (Nov. 19, 1992)). In particular, Bear Stearns projected that if no assets or branches were sold and no goodwill were written off, Long Island would have had at September 30, 1993 a tangible capital ratio of only 3.09%. DX 926 at 9-10. In addition, Bear Stearns calculated that Long Island would have had to sell $3.7 billion of assets to realize an amount of embedded gain sufficient to avoid selling branches. *Id.* at 9; Tr. 5587:24 to 5588:25 (Test. of Fuster). In that scenario, Long Island would have a 3.99% tangible capital ratio at September 30, 1993 and would not have been adequately capitalized under FDICIA. DX 926 at 10; Tr. 5589:1-24 (Test. of Fuster). Moreover, under that scenario, Long Island's future earning capacity would be impaired and its tangible capital in future years would have shrunk below even this

undercapitalized level. Projections indicated that Long Island would have incurred a loss of $25.3 million in the 1993 fiscal year and a $20.4 million loss in the 1994 fiscal year. DX 926 at 10; Tr. 5589:25 to 5590:9 (Test. of Fuster).

The government has also failed to prove that Long Island's mitigation in the form of a conversion was unreasonable, for reasons that mirror those explained by the court of appeals in *Home Savings IV*. In that case,

> Ahmanson[the parent company,] was entitled to raise funds to replace the supervisory goodwill Home [Ahmanson's wholly owned subsidiary] lost as a result of the government's breach. The duty of reasonable mitigation did not require Ahmanson simply to operate Home with a smaller capital cushion. As a conservatively run thrift, Home relied on a substantial cushion, and this prudence both appealed to Ahmanson's investors and helped Home gain regulatory approval to acquire failing thrifts. *Home III*, 57 Fed. Cl. at 727. Home was not required to abandon this successful business strategy merely to reduce the government's exposure. Rather, Ahmanson was entitled to cover the loss of supervisory goodwill by private capital financing in order to maintain its conservative approach.

399 F.3d at 1353.[22] As specified in Long Island Bancorp's prospectus issued in connection with the stock sale for the conversion, the holding company intended to downstream proceeds to the Bank in an amount sufficient for the Bank to achieve an 8% tangible capital ratio. DX 606 at 34 (Long Island Bancorp, Inc.'s Prospectus (Feb. 14, 1994)). The bank carried through with that statement of intention. See supra, at 631. The key question is whether the cushion reflected in that ratio was unreasonably large.

An expert witness retained by the government, W. Barefoot Bankhead, opined at trial that a capital level of 6% would have been prudent for Long Island and that a tangible-capital level in the 6.5%-8% range would have produced excess capital. Tr. 5633:25 to 5634:22 (Test. of Bankhead). Another of the government's expert witnesses, Dr. Andrew S. Carron, also testified that an 8% capital ratio was more than Long Island needed as a cushion. Tr. 5297:24 to 5298:5 (Test. of Carron). In Dr. Carron's view, the banks' pre-FIRREA capital ratio did not

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[22] This language in *Home Savings IV* squarely refutes the government's assertion that Long Island "had an obligation to mitigate the effects of the breach in the least costly manner to the defendant." Def.'s Br. at 59 n. 23. For purported support for its assertion, defendant cites to *LaSalle Talman Bank, F.S.B.* v. *United States*, 45 Fed. Cl. 64, 103 (1999), and *Bank United of Texas, FSB* v. *United States*, 50 Fed. Cl. 645, 654 (2001). These cases do not provide such support. Rather, the court in *LaSalle Talman* merely observed that "it is particularly inappropriate to resort to a hypothetical and unreasonably expensive method of replacing capital when the record shows the actual method of mitigation chosen." *LaSalle Talman*, 45 Fed. Cl. at 103. Similarly, nothing in *Bank United* comes close to the meaning the government ascribes to it.

constitute in economic terms a "revealed preference" for a capital ratio because the parent, Syosset, was a mutual association, and thus the banks had limited means of adjusting their capital ratio. Tr. 5092:12 to 5096:11 (Test. of Carron). "As a captive of its mutual parent," the government asserts, "Centereach had no choice but to possess the cushion that it had at the time of the alleged breach." Def.'s Br. at 57. Defendant contends that once Long Island converted, it no longer needed such a high capital ratio because, as its conversion business plan stated, it did not plan to grow beyond net interest credited or to acquire branches or open de novo branches. *Id.* at 57-58.

The government overlooks the benefits of increased capital. Such benefits are not limited to those associated with leveraging but rather, as Merrill Lynch advised the Bank prior to its conversion, "[i]ncreased capital provides greater operating flexibility and a cushion against unanticipated losses." PX 331 at LIP0155255 (Merrill Lynch's presentation to Long Island (Sept.1993)). As Mr. Fuster testified, those are the reasons he "wanted the [B]ank to have at least an 8 percent capital ratio going into its new existence as a public company. The IPO document [Prospectus] shows us at that 8 percent number, and the bank operated historically at that and wanted to continue at that level." Tr. 5580:12-16 (Test. of Fuster).

Moreover, neither Mr. Bankhead nor Dr. Carron conducted a peer analysis comparing Long Island's capital ratio to that of comparable institutions. See Tr. 5306:17 to 5307:5, 5308:2 to 5309:3 (Test. of Carron); Tr. 5643:9 to 5644:2 (Test. of Bankhead). Telling evidence of the capital ratios of peer banking firms is present, however, in the record. The

appraisal for Long Island prepared by RP Financial identified peer thrifts and indicated that the average capital ratio for peer institutions as of September 30, 1993 was 9.3%, PX 354 at 3.4 (Conversion Valuation Appraisal Report (Dec. 17, 1993)), significantly above the 8% target for a capital ratio that Long Island sought and achieved. Still further, another expert witness who testified on behalf of the government, Professor Haluk Unal, prepared an analysis that demonstrated that the average tangible-capital ratios for converting thrifts in his sample was 7.94% in 1993 and 8.25% in 1994. DX 3062 (Demonstrative showing amount of tangible net worths of converting thrifts (Mar. 7, 2000)); Tr. 5667:23 to 5668:21 (Test. of Unal). Based on these data, Long Island's targeted capital cushion of 8% was well within the range of those of its peers at the pertinent time.

In short, the government has failed to carry its burden to prove that Long Island's efforts to mitigate the loss of goodwill as regulatory capital and regain an 8% capital ratio were unreasonable.

d. *Reasonable certainty.*

Professor Charles W. Calomiris prepared a model to measure the costs incurred by the banks attendant to their replacement of supervisory goodwill with tangible capital. Professor Calomiris developed a schedule of such replacement capital based on the use for this purpose of the retained earnings from Syosset absorbed upon its merger into Centereach on September 3, 1993, and on the IPO proceeds downstreamed by Bancorp to Long Island in April 1994. Tr. 2600:7-13 (Test. of Calomiris). He started with a goodwill balance of $435,051,000 in Centereach as of September 3, 1993, amortized on a straight-line basis at a rate of $14.5 million per year.

Tr. 2601:3 to 2602:6 (Test. of Calomiris); PX 755 (Demonstrative showing amortization of contractual goodwill); PX 423 (Calomiris's Report (June 14, 2004)), Ex. F (Long Island's schedule of replacement capital).[23] He also determined that the banks were targeting a capital ratio of 8% on average both prior to and subsequent to FIRREA. Tr. 2607:16 to 2612:4 (Test. of Calomiris); PX 757 (Demonstrative showing Centereach's and combined entity's quarterly regulatory capital ratios); PX 758 (Demonstrative showing Syosset's quarterly regulatory capital ratios).

Next, Professor Calomiris calculated that the dividends of $66.3 million Long Island paid to Bancorp from April 14, 1994 through the merger with Astoria on September 30, 1998, resulted in an annual cost of 9.06% over the period of 4.46 years. Tr. 2632:10-19 (Test. of Calomiris); PX 423, Ex. G (Long Island's cost of replacement associated with the $164 million of downstreamed IPO proceeds). He also used that same annual cost of capital, 9.06%, to compute the cost of capital for the period from October 1, 1998 through 2023, by which time all of the regulatory goodwill would have been amortized, Tr. 2651:14-19 (Test. of Calomiris), and he used that same rate to calculate an imputed cost of the retained earnings. Tr. 2660:20 to 2661:1 (Test. of Calomiris).

To replicate the benefits of the replacement capital over the nearly thirty years remaining on the

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[23] Given this starting point, Professor Calomiris ignored the cost of replacement capital attributable to Centereach's retained earnings during the capital-plan period and to the cost of Syosset's cash contributions of approximately $9 million to Centereach's capital during that period. See *supra*, at 638-39.

life of the goodwill at the 1993 starting date for his calculations, Professor Calomiris selected the yield on a 30-year Treasury bond. Tr. 2643:1-15 (Test. of Calomiris). The 30-year Treasury rate on the date of Long Island Bancorp's IPO was 7.29%. PX 423 at 13. To account for the effect of taxes on the earnings from 30-year Treasury securities, Professor Calomiris used data provided via testimony by Anthony DiConstanzo, Astoria's tax manager, to calculate the tax rate for each year based on the marginal tax rates that Long Island paid and that Astoria paid or was projected to pay. Tr. 5384:20 to 5385:4 (Test. of Calomiris); PX 822 (Demonstrative showing Long Island's tax rates on U.S. Treasury income). For each year, he then computed the benefit received from the replacement capital, based upon the amount of goodwill replaced, the 7.29% yield for the 30-year Treasury, and the applicable tax rate.

From these calculations, Professor Calomiris determined net costs the banks incurred in connection with raising replacement capital. Professor Calomiris calculated these costs in several segments. He calculated the net costs of the IPO proceeds as amounting to $139,278,000, with the costs prior to September 30, 2005 on an undiscounted basis and the future costs, i.e., those after that date, on a discounted present-value basis as of September 30, 2005. PX 821A, Exs. E, G, H.[24]

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[24] Professor Calomiris testified that his revised calculation set out in PX 821A reflected actual net costs of replacement capital for each year up to September 30, 2005, the close of Long Island's fiscal year closest to the conclusion of the trial, and for years after that date, a discounting of the projected net costs by year back to September 30, 2005. Tr. 5386:15-17; Tr. 5389:8 to 5390:10; Tr. 5392:2-7 (Test. of Calomiris). This methodology as ultimately used by Professor Calomiris accords with the

For the retained earnings, he calculated that the net costs amounted to $113,185,000, again on the basis of undiscounted costs prior to September 30, 2005 and therefore on a discounted present-value basis as of September 30, 2005. PX 821A, Exs. E, I. Thus, the total net costs on an undiscounted basis prior to September 30, 2005, and thereafter on a present-value basis discounted to September 30, 2005, as measured by Professor Calomiris, equaled $252,464,000. Tr. 5387:2-4 (Test. of Calomiris); PX 821A, Ex. E.

The government raises several arguments directed at particular aspects of Professor Calomiris's cost-of-replacement model.[25] Those

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Federal Circuit's decision in *Energy Capital Corp.* v. *United States*, 302 F.3d 1314, 1330 (Fed. Cir. 2002) ("*Energy Capital II*").

In earlier calculations, Professor Calomiris discounted net costs of replacement capital back to 1989, the date of the breach, see PX 422 at 11 (Report of Charles Calomiris (April 21, 2003)), or back to September 30, 1998, after the merger with Astoria, see PX 423 at 4 (Report of Charles Calomiris (June 14, 2004)), or to September 1993, the date of Syosset's merger into Centereach. See *id.* at 16-18. For these prior calculations, Professor Calomiris used dates for his discounting calculations that were requested by counsel. Tr. 2654:20 to 2656:9, Tr. 2949:15-22 (Test. of Calomiris).

[25] The government also makes its perennial argument in *Winstar*-related litigation that transaction costs represent the only costs associated with raising capital. Recognizing that the Federal Circuit has consistently rejected that argument, see, *e.g.*, *LaSalle*, 317 F.3d at 1374-75; *Home Savings IV*, 399 F.3d at 1354, the government asserts that the Supreme Court's decision in *Dura Pharmaceuticals, Inc.* v. *Broudo*, 544 U.S. 336 (2005), "establishes" that the court of appeals in *Home Savings* and *LaSalle* "erred in affirming the rejection of the transaction-costs measure." Def.'s Br. at 60. *Dura Pharmaceuticals* is

arguments largely ignore the decisions of the court of appeals in *LaSalle* and *Home Savings IV*, and persuasive decisions of this court.

First, the government argues that Professor Calomiris's calculation of the costs of retained earnings "includes hypothetical dividends." Def.'s Br. at 65. Syosset merged into Centereach, and Syosset thus contributed its retained earnings; those retained earnings were essential to keep the merged entity afloat. In that regard, the depositors of both institutions received inchoate rights to the retained earnings and to future capital appreciation, realizable particularly upon conversion. When conversion occurred less than a year after the merger, the depositors responded to the public offering by oversubscribing to the "super maximum," recognizing the embedded value in the franchise in the form of retained earnings, strong capacity for future earnings, high-quality management, and prime location. The depositors bought all of the stock newly purchased at conversion (90% of the converted

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inapposite to a measurement of the costs of replacing supervisory goodwill with tangible capital. In *Dura Pharmaceuticals*, the Supreme Court held that in a securities fraud action, an inflated stock price does not by itself prove a causal connection between a material misrepresentation of the stock and a shareholder's loss. *Dura Pharm.*, 125 S.Ct. at 1632-33. The government reasons that "*Dura Pharmaceuticals* contradicts ... [t]he approach adopted in *Home Savings* and *LaSalle* [, which] bases damages upon the happenstance of any post-issuance divergence between the expected values of the dividends and the return on the new capital." Def.'s Br. at 61. To the contrary, as plaintiffs observe, the divergence manifested in measurements of costs of replacement capital results not from happenstance but from the reality that supervisory goodwill has no capital costs, whereas tangible capital does have such costs. See Pls.' Reply at 19.

entity's total stock issuance), essentially keeping intact their equitable (and now legal) ownership of the retained earnings. The other 10% of the shares were issued for the Bank's newly created employee stock option plan and its management retention plan, so no "outsiders" were involved in the transaction. The retained earnings thus had significant value, and the stockholders (prior depositors) had every expectation of a return on them as well as on their newly paid-in capital. That return was realized upon the merger with Astoria in the form of capital gains of 38% on an annual basis. See *supra*, at 632. The shareholders did not have a right to any particular rate of return on the retained earnings, just as they had no right to a particular dividend rate on their stock. However, they certainly had an expectation of a return on the retained earnings, just as they had an expectation of a dividend on their stock. In short, in the particular circumstances of this case, the retained earnings had a recognizable and substantial value, the equitable rights to those retained earnings inhered in the depositors who became the shareholders in the Bank, and those shareholders within a relatively short time realized value from their right to the retained earnings. Although it would not be appropriate to recognize as a cost of replacement capital the entire 38% annual return that the shareholders realized, it would be appropriate to recognize approximately one-quarter of that annual return, 9.06%, as an imputed cost of the retained earnings. In these circumstances, it is appropriate to apply the dividend rate of 9.06% both to the newly paid-in capital and to the retained earnings.

Second, the government raises a related but somewhat contradictory argument that Professor

Calomiris's model "overstates the cost of capital because it fails to account for the fact that the earnings from which the dividends were paid during the 1993-98 time period were facilitated not only by the $164 million in down-streamed IPO proceeds but also by the $271 million in tangible capital that was already there at the time of conversion." Def.'s Br. at 66. Unlike the circumstances in *LaSalle Talman*, however, Long Island "paid 100% of its dividends on 100% of its outstanding stock, all of which was acquired in exchange for $164 million in IPO proceeds." Pls.' Reply at 22; see also *LaSalle Talman*, 64 Fed. Cl. at 112.

Third, the government argues that a portion of the dividends the Bank paid to Long Island Bancorp reflects a return "of" capital rather than a return "on" capital. Def.'s Br. at 67 (citing *LaSalle II*, 64 Fed. Cl. at 111). In particular, the government points to Mr. Fuster's letter of January 31, 1995 requesting a waiver of the prohibition on repurchases of stock within one year of conversion. *Id.* at 67-68 (citing DX 1898 (Letter from Fuster to Douglas J. Cestone, Deputy Head of Corporate Activities, OTS (Jan. 31, 1995))). However, the proposed buyback referred to capital held at the holding company level, not capital at the Bank. The holding company, Bancorp, had retained $100.4 million of the newly paid-in capital, and it was that capital retained at the Bancorp level that was used to buy back stock, not the capital that Bancorp had downstreamed to Long Island.

Fourth, defendant contends that Professor Calomiris's calculation of benefits is hypothetical because Long Island did not actually invest in U.S. Treasuries. Def.'s Br. at 68; see also Def.'s Reply at 10. However, Professor Calomiris explained that a

30-year Treasury represents the only asset that could replicate the characteristics of the remaining life of Long Island's goodwill. Tr. 2643:1 to 2644:24 (Test. of Calomiris). In similar circumstances, the court of appeals in *Home Savings IV* determined that an offset based on "the rate paid for a comparable government-backed asset" "'account[s] for the difference between what was lost and what was substituted.'" 399 F.3d at 1354 (quoting *Home Savings III*, 57 Fed. Cl. at 723). In addition, Long Island actually owned U.S. Treasury securities in significant quantities, totaling approximately $147 million as of September 30, 1994, so Professor Calomiris's calculation of benefits in this instance is supported by the Bank's circumstances, even though the Treasury securities held by Long Island undoubtedly were not 30-year obligations. PX 391 at 44 (Long Island Bancorp, Inc.'s annual report (1994)).

The government's fifth argument is that plaintiffs' "model is nothing more nor less than a purely mathematical formula that calculates the profits that could have been earned on the goodwill had it been leveraged." Def.'s Br. at 68; see also Def.'s Reply at 11. This contention is wrong. Professor Calomiris's model does not purport to measure damages from leveraging. As in *Home Savings IV*," [h]ere, the plaintiffs do not seek profits they believe they would have made from leverage; they seek the cost of replacing goodwill with tangible capital." 399 F.3d at 1355 n.8.

Sixth, the government argues that the timing of the two sources of capital infusion in Professor Calomiris's model is "counter-factual" because the IPO proceeds are factored into the model prior to the

retained earnings. Def.'s Br. at 70. However, Professor Calomiris analyzed whether the sequential timing of these two acts of mitigation was material in measuring the costs of capital, and he demonstrated it was not. Specifically, he observed that required returns on equity would have been higher in 1993, the date of the merger and the date of Syosset's contribution of its retained earnings to the merged institution, than in 1994, the date of the conversion. Tr. 2661:23 to 2662:3 (Test. of Calomiris). Moreover, in 1993 Long Island was more leveraged than it was in 1994, so its cost of equity capital would have been higher. Tr. 2662:4-19 (Test. of Calomiris); PX 778 (Demonstrative showing the relative net costs of retained earnings and IPO proceeds).

Lastly, the government surmises that Long Island would have converted regardless of the breach and would have written off its remaining goodwill, which write-off the government asserts would have been a condition imposed by the Securities Exchange Commission ("SEC") to regulatory approval of a conversion. Def.'s Br. at 70-71. Defendant's argument is speculative in that it hinges on a possibility that did not exist at the time of the breach. Indeed, the government's own description of SEC's regulatory authority indicates that SEC could have taken alternative courses of action. Def.'s Br. at 70. In the government's words, "the SEC would have required either that SFAS No. 72 be adopted, in which case nearly all of the goodwill would have been eliminated prior to conversion ..., or, at a minimum, the SEC would have required a reduction of the amortization period from 40 to 25 years." *Id.* at 70-71. In this respect, by the time of conversion, over ten years would have already elapsed on Centereach's original 40-year amortization schedule. Moreover, apart from

the SEC's uncertain posture, the government did not present evidence regarding what OTS could or would have done in relation to Long Island's goodwill in a non-breach circumstance. Finally, neither OTS nor the banks' investment bankers believed that the banks could have converted in the years immediately following the breach. Tr. 1081:24 to 1082:11 (Test. of Viklund). Conversion was a possibility that OTS urged the banks to consider on a continuous basis as the capital-plan period unfolded and as the banks' condition continued to improve. See *supra*, at 641.

e. *Computation of present value.*

When awarding expectancy damages, a court must discount those damages that would have been incurred in the future to avoid unjustly enriching the plaintiff. See *Energy Capital II*, 302 F.3d at 1330; see also *Energy Capital Corp.* v. *United States*, 47 Fed. Cl. 382, 415 (2000) ("*Energy Capital I*") (stating that the "value of a particular sum of money presently held is greater than the value of the same to be received in the future."). Damages are generally calculated and valued as of the date of the breach, except for expectancy damages that but for the breach would have been received in the future as part of a continuing contract. *Energy Capital II*, 302 F.3d at 1330. Future damages, *i.e.*, damages extending beyond the date of judgment, are addressed by applying a discount rate to obtain the present value of such damages as of the date of judgment. *Id.* ("Discounting future lost profits to the date of judgment merely converts future dollars to an equivalent amount in present dollars at the date of judgment; it is not an award of prejudgment interest and does not violate sovereign immunity."); see also *Northern Helex Co. v. United States*, 225 Ct. Cl. 194,

634 F.2d 557, 564 (1980); *LaSalle Talman Bank, FSB* v. *United States*, 45 Fed. Cl. 64, 109 (1999). In this instance, Professor Calomiris applied these principles to discount the future-damages portion of the calculated cost of replacement capital to September 30, 2005. Tr. 5445:10-19 (Test. of Calomiris); PX 821; PX 821A Exs. E, F, H, I.

Determining the appropriate discount rate is a question of fact for the court. *Energy Capital II*, 302 F.3d at 1333. "[C]onservative investment instruments should be applied in making that determination. *Id.* Furthermore, although not required, the court may also take into account any potential future investment risks that plaintiffs might face, and adjust the discount rate accordingly." See also *id.* The court of appeals noted that it is appropriate to use a risk-free discount rate, such as the interest rate in treasury securities, when no evidence concerning a discount rate has been presented at trial. *Id.* In this case, Professor Calomiris explicitly used a discount rate of 9.04% based on the average annual dividend rate paid by Long Island to Long Island Bancorp from 1994 to 1998. PX 821A Exs. E, F, H, I. Faced with this evidence, the burden shifted to the government to produce countervailing credible evidence on the discount rate, and it failed to do so in this case. See *Energy Capital I*, 47 Fed. Cl. at 419-20 (citing *Alma* v. *Manufacturers Hanover Trust Co.*, 684 F.2d 622, 626 (9th Cir. 1982)).

Therefore, the court will discount the future cost-of-replacement-capital expectancy damages to the date of judgment, which the court will specify shall issue on September 30, 2005, at a rate of 9.06%. As of

that date, the total cost of replacement capital amounts to $252,464,000.

2. *Lost profits.*

Long Island also claims additional expectancy damages in the form of profits lost by plaintiffs as a consequence of a breach of contract. Pls.' Br. at 66-75. In this respect, the Federal Circuit has stated that "[t]he benefits that were expected from the contract, 'expectancy damages,' are often equated with lost profits, although they can include other damage elements as well." *Glendale Fed. Bank*, 239 F.3d at 1380 (Fed. Cir. 2001) (citing *Restatement (Second) Contracts* § 347).

On plaintiffs' behalf, Dr. Nevins Baxter created a model to calculate the amount of profits lost due to the sale of deposit franchises, *i.e.*, deposits and branches. In creating his model, Dr. Baxter employed an eight-step process to calculate the deposit-franchise damages. PX 702 (Demonstrative showing the methodology of Dr. Baxter). He began by measuring the size of the deposit losses caused by three distinct events. *Id.* First, in late 1992, multiple news stories publicized the potential for numerous bank failures in the United States, including that of Centereach, because they were classified as critically undercapitalized. PX 274 (Transcript of broadcast of NBC story (Nov. 10, 1992)); PX 280 (Newsday article entitled "TV Reports Panic LI Savings Corporation" (Nov. 13, 1992)); PX 286 (Money Magazine article indicating Centereach as one of 40 critically undercapitalized banks (Dec. 1992)). Dr. Baxter noted that the bank suffered "significant deposit losses" during the same time period, PX 30 Revised (Summary of the banks' average monthly deposit balances (Apr. 1994)), and he testified that the only

logical explanation for the loss of deposits was the negative publicity. Tr. 2265:7 to 2266:16, 2269:15 to 2270:19 (Test. of Baxter).

The second event to which he pointed was the announcement of the sale of multiple branches to Home Savings. PX 309 (Joint press release announcing sale of branches (Apr. 29, 1993)). Dr. Baxter calculated the subsequent loss of deposits from the branches to be sold at approximately $114 million, PX 803 (Demonstrative of deposit runoff in the sold branches), and he opined that such losses were caused by customers' unease over the impending sale. Tr. 5498:10 to 5499:14 (Test. of Baxter). Dr. Baxter compared the decline in deposits at the ten branches to be sold to the other branches operated by the banks, concluding that the "non-sold branches suffered no losses and that the reduction in the deposits ... [subsequent to the sale announcement] was solely attributable to the sold branches." Tr. 5500:20 to 5502:16 (Test. of Baxter); PX 804 (Demonstrative showing the reduction in the bank's deposits).

Dr. Baxter's third event was the actual sale of branches to Home Savings, resulting in a transfer of approximately $836 million of deposits. Tr. 2270:19-20 (Test. of Baxter).

Dr. Baxter also examined the sale of earning assets belonging to both Syosset and Centereach. Tr. 2302:9-13 (Test. of Baxter).

From these starting points, Dr. Baxter sought to emulate what the banks would have gained had the deposit reductions not occurred and the assets not been sold. Tr. 2302:16 to 2303:24 (Test. of Baxter); PX 712 (Demonstrative showing deposits being

hypothetically replaced). Dr. Baxter further included additional assets according to the banks' ratio of actual borrowings to deposits to reflect the growth, albeit limited, that the banks might have experienced had the sale of assets not occurred. Tr. 2305:1-24 (Test. of Baxter); PX 714 (Demonstrative showing actual average deposits and borrowings); PX 715 (Demonstrative calculating the earning assets for the bank in a non-breach scenario).

Dr. Baxter proceeded to compare the incremental and actual banks. Assuming that they would have had the same management and investment strategies, covered the same geographic area, and held the same type of assets, he opined that the incremental bank would have been "at least as profitable" as the actual bank. Tr. 2314:21 to 2316:24, Tr: 2325:19-21 (Test. of Baxter). He correspondingly multiplied the incremental banks' assets by the banks' actual Return on Average Assets ("ROAA"). Tr. 2325:25 to 2326:5 (Test. of Baxter). This calculation produced Dr. Baxter's postulated profits lost between fiscal years 1993 and 1998, totaling approximately $91 million. PX 720 (Demonstrative applying actual ROAA to incremental franchise assets). Finally, the premium that the banks received from the sale of the franchises was subtracted from these gross lost profits to leave approximately $78 million in lost-profit damages. *Id.*

The government vigorously contests any award of lost profits based upon Dr. Baxter's calculations. Def.'s Br. at 37-52. Among other things, the government contends that deposits were not lost due to adverse publicity but rather to disintermediation and other factors, *id.* at 41, that Dr. Baxter's opinion

regarding loss of deposits after the announcement of the sale of branches is purely subjective because he did not conduct an event analysis or peer-group analysis to confirm his assumption, *id.* at 42, and that the sale of branches and attendant deposits was not caused by the breach. *Id.* at 38-40. The government also criticizes Dr. Baxter's model because it applies to bank-wide return on average assets rather than the return on the assets actually sold, *id.* at 44-47, and because he failed to take account of the gain of roughly $47.8 million realized on the assets that were sold. *Id.* at 47-48. In general, the government asserts that Dr. Baxter's model produces results that are too speculative and uncertain to be used as a basis for awarding expectancy damages. *Id.* at 44-49 (citing particularly *Wells Fargo Bank* v. *United States*, 88 F.3d 1012 (Fed. Cir. 1996)).

Plaintiffs themselves place a caveat on Dr. Baxter's calculations of lost profits. They concede that if the court should award cost-of-replacement-capital damages as derived by Professor Calomiris for the period from September 1993 through September 1998, "then it would be unnecessary for the [c]ourt to reach the validity of deposit[-]franchise damages as calculated by Dr. Baxter." Pls.' Br. at 66. Because the court has found that expectancy damages in the form of the banks' costs of mitigation, *i.e.*, their costs of replacing the goodwill as capital, should be awarded without a carve-out of the period from September 1993 through September 1998, see *supra*, at 644-48, the court will apply plaintiffs' concession to forestall any award of lost profits in this case. Notably, the banks achieved a full mitigation of the government's breach by replacing all of Centereach's supervisory goodwill with

tangible capital. Any additional award of expectancy damages would in essence constitute a windfall. Although it is true that the bank resulting from the mitigating transactions was $1 billion smaller than the banks before the breach, the difference in size does not by itself constitute a ground for awarding lost-profits damages in addition to the damages directly attributable to the banks' successful efforts at mitigation. Thus, it is unnecessary to consider the government's specific objections to Dr. Baxter's model.

3. *Reduced IPO proceeds.*

The banks have also sought to recover allegedly reduced IPO proceeds that they would have received but for the breach. Ronald Riggins, president of RP Financial, analyzed what Long Island's value would have been at conversion, absent a breach by the government. Pls.' Brief at 57. Mr. Riggins operated under the assumptions that the supervisory goodwill would have been retained by Long Island and the restructuring of the banks did not occur, but the Bulk Sale of assets would have been completed. Tr. 1720:4 to Tr. 1721:16 (Test. of Riggins); PX 426 30, 37, 39-40, 42-43 (Riggins' report on Long Island's non-breach conversion valuation (Oct. 25, 1999)). With these assumptions, he opined that Long Island would have had an annual valuation-earnings base of $39.6 million, $9.2 million higher than in his original appraisal. PX 426 42, Ex. 4.

In preparing his analysis, Mr. Riggins used financial data from Long Island as of August 31, 1993, with certain adjustments based on the aforementioned assumptions. Tr. 1726:11 to 1727:8, 1730:23 to 1732:8 (Test. of Riggins); PX 583 (Demonstrative of the financial data used for a non-

breach appraisal). Mr. Riggins created, as in the original appraisal, a range of Long Island's value, with a midpoint, had a breach not occurred, of $300 million. Tr. 1750:4 to 1751:17 (Test. of Riggins); PX 590 (Demonstrative as to Long Island's non-breach appraisal range of value). Mr. Riggins also opined that Long Island's actual value, had it converted without the breach, would have been at the super-maximum, 15% above the maximum value, equaling $396.75 million. Tr. 1751:18-23 (Test. of Riggins); PX 426 53. Therefore, Mr. Riggins asserted that without the breach, Long Island would have received an additional $97.4 million in IPO net proceeds.

Nevertheless, the plaintiffs should not be awarded any damages measured by reduced IPO proceeds. This measure in effect replicates, or serves as a surrogate for, damages premised upon the emergence of a smaller bank after the banks carried out their mitigating actions. An award based upon reduced IPO proceeds would be just as inappropriate and duplicative as would an award of lost profits.

4. *Incidental losses.*

The banks seek incidental-expense damages in six categories that they claim they would not have incurred but for the breach of contract by the government. Termed "incidental losses" by the Restatement, plaintiffs are entitled to recover such losses insofar as "they protect the injured party's expectation interest but are separate and distinct from" the cost of replacement capital. *Globe Savings*, 65 Fed. Cl. at 361 (citing *Restatement (Second) Contracts* § 347 cmt. c).

a. *Excess deposit insurance costs.*

The banks first assert that as a result of the government's breach, Centereach paid excess deposit insurance premiums. Tr. 401:2-23 (Test. of Fuster); PX 31 at 2 (Excess Costs of Deposit Insurance (1999)). Prior to FIRREA, both Centereach and Syosset were rated equally with a composite rating of "2" under the MACRO system and paid the same premiums, see PX 35 (Demonstrative summarizing ratings for Syosset, Centereach, and Long Island Bancorp); PX 35A (supporting materials for PX 35), but afterwards Centereach's rating was reduced to a 4. PX 249 (Letter from Vigua to Nacos (March 25, 1992)). The banks claim that Centereach's lower rating after the breach caused it to incur higher deposit insurance payments to the FDIC's Savings Association Insurance Fund ("SAIF"). Pls.' Br. at 64. The premium Syosset paid during these periods was 0.115% compared to Centereach's rate of 0.155%. Using the rate paid by Syosset as the asserted rate that Centereach would have paid in a non-breach situation, and then calculating the excess premium that Centreach paid during this time period, plaintiffs claim that they suffered $1,912,600 in damages. PX 31A at PX031A-0001 to 0005 (FDIC's SAIF Certified Statements); see also PX 724 (Demonstrative showing schedule of SAIF premium rates).

The government asserts that such figures are speculative and that the banks have offered no proof that Centereach's overall risk assessment, and thus its insurance premium costs, would have been any different in a non-breach world. Def.'s Br. at 79. Specifically, the government contends that the continued use of supervisory goodwill would simply have been "an accounting difference" and would not

have been a "real change in Centereach's risk profile." *Id.*

The court finds the government's argument unavailing. The banks have proven that Centereach's risk assessment fell to a 4 because of "the institution's insolvent regulatory capital position" that was caused by the government's breach upon the passage of FIRREA. PX 249 (Letter from Vigna to Nacos (Mar. 25, 1992)). This drop in Centereach's MACRO rating was the direct cause of higher deposit insurance charges. Tr. 3202:13-18, 3213:6-9 (Test. of Stephen Rohrs, an Assistant District Director of OTS in New York during the pertinent time); Tr. 3247:17 to 3250:23 (Test. of John Robinson, an Assistant District Director of OTS for policy at the pertinent time); Tr. 3326:20-3327:3 (Test. of Michael Simone, Assistant District Director of OTS in New York at the pertinent time). Therefore, the banks' claim for excess deposit insurance costs is accepted as proven.

b. *Excess OTS examination costs.*

The banks also seek as incidental damages higher OTS examination costs that Centereach was required to pay in 1992 and 1993. Tr. 402:14 to 403:10 (Test of Fuster); PX 31 at 3. Centereach's poorer MACRO rating triggered the premium-assessment provision indicated in Thrift Bulletin 48 as Centereach was now considered a "troubled institution." PX 249 (Letter from Vigna to Nacos (March 25, 1992)) ("Because of the assigned MACRO rating, Centereach is considered a troubled institution and must pay the premium assessment as indicated in Thrift Bulletin 48."). Using the assessment schedule for Syosset, the banks calculated the excess examination costs by

comparing what Centereach would have been charged had their MACRO rating remained equal to Syosset's versus their actual payments following the breach.

As with deposit insurance costs, the government again asserts that the figures offered by the banks are too uncertain to determine what, if any, excess examination costs Centereach might have paid. Def.'s Br. at 78-79. In particular, the government argues that plaintiffs' calculations are founded on hypothetical activity of OTS; specifically, the belief that OTS would have still provided Centereach a MACRO rating of 2 if supervisory goodwill was available.

The court is persuaded by the evidence that Centereach paid excess OTS examination costs because of the breach by the government. During 1992 and 1993, Centereach paid $1,307,372 in examination costs to OTS, in contrast to Syosset, which paid $871,582 in examination fees assessed at the general rate as a result of its stronger MACRO rating. PX 31 at 3. The differing treatment is attributable solely to the disallowance of Centereach's goodwill as regulatory capital. Consequently, the banks are entitled to incidental losses measured by excess OTS examination costs of $435,790. *Id.*; PX 31A at PX031A-0007 to 0013, 0043 (OTS Assessments and the banks' data).

c. *Capital-plan costs.*

The banks also claim as incidental losses the costs they incurred in the preparation and implementation of Centereach's capital plans. The banks seek expenses paid to four firms: KPMG Peat Marwick ("Peat Marwick"), Goldman Sachs, Simpson

Thacher & Bartlett ("Simpson"), and Wilmer Cutler & Pickering ("Wilmer"). PX 31 at 4. The banks presented bills, invoices, and charges by these firms for work completed through September 1993 on the capital plans. Id; Tr: 404:16-21 (Test. of Fuster). In some instances, a vendor worked on matters other than the capital plans during a billing period, without separately breaking out the charges for services related to the plans. Tr. 406:1-6 (Test. of Fuster). In those instances, Mr. Fuster allocated 10% of the cost to capital-plan expenses. Tr. 405:4 to 406:8 (Test. of Fuster). The government has countered that some of the allocations made by Mr. Fuster were "arbitrary, and unreliable." Def's. Br. at 78. In his testimony, Mr. Fuster admitted that he could not recall exactly what portion of the expenses were attributable to the capital plans and that his allocations were based purely on his own judgment. Tr. 471:13 to 492:5 (Test. of Fuster).

The court finds that those claimed expenses derived by Mr. Fuster's allocations have not been proven to a reasonable certainty. Therefore, in calculating the incidental losses attributable to work on the capital plans, the court excludes $64,031 attributed to Simpson. DX 4002 (Simpson bill # 1 (Mar. 28, 1990)); DX 4003 (Simpson bill # 2 (May 18, 1990)); DX 4004 (Simpson bill # 3 (Nov. 13, 1990)); DX 4005 (Simpson bill # 4 (Apr. 17, 1991)); DX 4006 (Simpson bill # 5 (Sept. 18, 1991)); DX 4007 (Simpson bill # 6 (Mar. 30, 1992)); PX 32A, tab 38 at PX032A-0250 to 253. For the same reasons, the court excludes $4,814 allocated from bills rendered by Wilmer, DX 4029 (Summary of transaction costs paid to Wilmer); PX 32A, tab 42 at PX 032A-0281, 282, 286, along with a further $6,099 paid to Wilmer on the ground that bills rendered by Wilmer dated April

30, 1990 and May 14, 1990 are duplicative. DX 4009 (Wilmer bill # 2 (Apr. 30, 1990)); DX 4010 (Wilmer bill # 3 (May 14, 1990)).

However, the court finds that $17,664 paid by the banks to Wilmer in early 1990 should have been classified as part of the work on the capital plans rather than being attributed to merger expenses. DX 4008 (Wilmer bill # 1 (Jan. 2, 1990)); see Tr. 492:6 to 495:3 (Test. of Fuster). Consequently, this payment is included as an incidental loss relating to work on the capital plans instead of merger expenses.

As a result, the court determines that the banks paid fees, expenses, and charges attributable to preparation and implementation of Centereach's capital plans as follows: $200,738 to Goldman Sachs for capital-plan costs from 1990 to 1991, PX 32 at 4; PX 32A, tab 16 (Capital plan costs paid to Goldman Sachs); $46,550 to Peat Marwick for similar expenses incurred in 1993, DX 4000 (Peat Marwick bill # 1 (Jan. 7, 1993)); DX 4001 (Peat Marwick bill # 2 (Aug. 30, 1993)); $67,568 to Simpson for such expenses, PX 32A, tab 38 at PX032A-0232 to 237, 256-257; and $256,145 to Wilmer in fees and charges for work pertaining to the capital plans. Tr. 405:4 to 406:13 (Test. of Fuster); DX 4008; DX 4009; DX 4011 (Wilmer bill # 4 (Apr. 5, 1993)); DX 4012 (Wilmer bill # 5 (Apr. 28, 1993)); DX 4013 (Wilmer bill # 6 (Aug. 5, 1993)); DX 4014 (Wilmer bill # 7 (Aug. 30, 1993)); DX 4015 (Wilmer bill # 8 (Oct. 1, 1993)); DX 4016 (Wilmer bill # 9 (Nov. 30, 1993)); PX 32A, tab 42 at PX 032A-0279 to 280, 284, 289. Therefore, the court awards $571,001 to the banks in damages for incidental losses attributed to capital-plan expenses.

d. *Branch and associated asset-sale costs.*

Mr. Fuster also testified as to losses the banks incurred as a result of three matters relating to the sale of branches and assets in 1993 and 1994: the sale of HELOCs, the sale of branches, and the sale of some secured mortgages. Tr. 406:14-25 (Test. of Fuster). In total, the banks incurred costs of $5,106,503 on the three sales through payments to a variety of vendors. PX 31 at 5. This is the sole claim for damages that is not disputed by the government. The government disputes only the banks's payment of approximately $1.9 million payment to Capital Markets Assurances Corporation for the purpose of insuring the package of HELOCs that was offered to purchasers. Def.'s Br. at 76. However, the government has not met its burden of proving that the insurance of the HELOCs package was an unreasonable mitigating step by the banks. See *Long Island*, 60 Fed. Cl. at 90. The government does not contest that the provision of insurance was useful. The insurance enhanced the market for the securitized package of HELOCs and it added to the net receipts on the sale by the banks. Tr. 5080:2 to 5081:7, 5373:13 to 5375:8 (Test. of Dr. Carron). Its objection instead seems to be that the benefits should be credited, that the benefits presumably exceeded the costs, and that as a result the item should simply be excluded. Tr. 5374:1-15 (Test. of Carron). That same overarching contention could be made for any of the costs of taking the mitigating steps because, overall, the banks' efforts at mitigation were successful even though costs were incurred in the process. Moreover, regarding the particular transaction, the evidence in the record is insufficient for the type of detailed parsing sought by the government. Thus, the court awards $5,106,503 to

the plaintiffs for incidental losses incurred pursuant to the costs from the sales of branches and assets.

e. *Conversion expenses.*

The banks also seek recovery of the expenses incurred to convert to a stock company. Mr. Fuster testified that in most instances, the banks could not retrieve the actual bills from vendors for aiding in the conversion. Tr. 410:1 to 411:6 (Test. of Fuster). As a result, while bills were provided for some companies, the majority of charges were derived from a report made for a 1993 IRS audit. Tr. 410:1-8 (Test. of Fuster); DX 4018 (Report prepared for 1993 IRS audit (June 30, 1994)). The government urges the court to find a lack of reasonable certainty in this calculation of conversion expenses damages on the ground that "many of the costs ... were compiled ... by an accounting firm ... from a document ... purportedly for an" IRS audit. Def.'s Br. at 77.

Based on the evidence, the court agrees with the banks in part and the government in part. Helpfully, Mr. Fuster's calculations of conversion expenses are similar to Dr. Carron's, the government's expert witness. See Tr. 5127:5-16 (Test. of Carron); DX 3147 (Demonstrative of the banks' conversion details, including expenses of $11,437,461). The banks initially sought $11,596,975 as incidental expenses related to the conversion. See PX 32 (Summary of expenses related to conversion). Of this initial claim, the court allows the following expenses related to the conversion, listed on an item-by-item basis: (1) $7,224 paid to American Banknote for production of stock certificates, see DX 4017; PX 32; PX 32B, tab 2;

[26] Tr. 408:22 to 409:9 and 502:5 to 503:8 (Test. of

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[26] Plaintiffs' Exhibits 31A, 32A, and 32B were identified at trial as volumes of exhibits containing detailed documentary materials supporting the summaries that were admitted into evidence as PX 31 and PX 32 under Fed. R. Evid. 1006. See Tr. 397:12 to 399:8 (Test. of Fuster). The volumes of documentary materials identified as PX 31A, PX 32A, and PX 32B were used by counsel and the witnesses during direct examination and cross examination at the trial in addressing particular elements of the cost summaries.

PX 32, PX 32A, and PX 32B relate specifically to conversion expenses. The government puts these exhibits in issue by arguing in its post-trial brief that the admission of PX 32 should be revisited and that this exhibit now should be elided from the record because that summary was compiled from unreliable sources and reflects subjective allocations of expenses within categories. See Def.'s Br. at 77-78 (citing *United States* v. *Bray*, 139 F.3d 1104, 1110 (6th Cir. 1998)). The court declines this invitation. PX 32 was admitted into evidence at trial only after extensive, detailed examination of Mr. Fuster about its genesis and the underlying factual support for it. See Tr. 589:20 to 590:7 (ruling of the court regarding admissibility of PX 32). See also Tr. 499:19 to 597:23 (cross-examination and argument about the documents underlying PX 32, which documents included DX 4017, which was admitted for limited purposes as a demonstrative, and DX 4018 through 4030, which were admitted for all purposes).

Moreover, contrary to the government's argument, the Sixth Circuit's ruling in *Bray* actually supports the court's decision at trial to admit the summaries as evidence under Fed. R. Evid. 1006. There, as here, the trial court admitted summaries as evidence only after the elements for admissibility under Rule 1006 had been established at trial, namely:

> the summarized writings must be so voluminous so as to be unable to be conveniently examined in court[;] ... the underlying evidence must itself be admissible[;] ... the original or copies of the summarized writings must be made available to the opposing party [;] ... [a]nd ... the proposed summary (or chart or calculation) must accurately

summarize (or reflect) the underlying document(s) and only the underlying document(s).

Bannum, Inc. v. *United States*, 59 Fed. Cl. 241, 244-45 (quoting *Bath Iron Works Corp.* v. *United States*, 34 Fed. Cl. 218, 232-35 (1995), *aff'd*, 98 F.3d 1357 (Fed. Cir. 1996)).

In admitting PX 31 and PX 32 as summaries, the court warned the parties that it would examine the detailed documents making up these summaries in deciding the incidental-loss aspect of the case:

> [THE COURT:] Plaintiffs' Exhibit 31 is admitted. (The document referred to, previously identified as Plaintiff's Exhibit No. PX 31, was received in evidence.)
>
> ... When I say it's admitted, it's admitted for evidentiary purposes. This is not to say that the Court is going to accept every factual inference that Mr. Fuster drew from the particular data that were made available. And the Court wants to draw that distinction quite strongly, because the Court might well, in the end, in its findings of fact, draw different inferences and reach a different result.
>
> Now let's turn to Plaintiffs' Exhibit 32. This also is admitted as a summary under Rule 1006. Again, this particular exhibit contains or reflects some data directly taken from documents that either are in evidence or otherwise were provided to Defendant as a result of and in the process of discovery. It contains mathematical calculations and reflects other judgments by Mr. Fuster and indeed perhaps some others.
>
> While the Court admits the document, the Court does not necessarily, by admitting it, indicate in any way that it is inclined to accept all of the inferences that are spelled out or underlie or are embedded in that particular summary.

Tr. 589:7 to 590:7. Given the government's argument in its post-trial brief, the court's above-quoted warning during trial, and the court's subsequent action in reviewing the documents underlying the summaries, the court now incorporates the volumes of documents identified as PX 31A, PX 32A, and PX 32B into the record as demonstrative, or pedagogical, material that serves to render the summaries and the testimony of witnesses at trial more understandable. See *Bannum*, 59 Fed.

Fuster), (2) $602,838 paid to Chemical Securities and Trust Services, see PX 32; PX 32B, tab 8, (3) $33,279 paid to Duff & Phelps, see PX 32; PX 32B, tab 12, (4) $325,601 paid to KPMG Peat Marwick, see PX 32; PX 32B, tab 19 at PX 032B-054 to 55, 58, 59, 78-80, 84, 87-97; Tr. 409:10-23 (Test. of Fuster), (5) $195,130 paid to Mark Services Inc., see PX 32; PX 32B, tab 20; Tr. 410:1-14, 514:23 to 515:9 (Test. of Fuster), (6) $3,006,620 paid to Merrill Lynch Co., see PX 32; PX 32B, tab 22, (7) $1,261,282 paid to Milbank Tweed, see PX 32; PX 32B, tab 23; Tr. 412:22 to 413:12, 526:13 to 539:10 (Test. of Fuster),[27] (8) $5,199 paid to Morris, Nichols, Arsht & Tunnell, see PX 32; PX 32B, tab 25, (9) $50,000 paid to NASDAQ, see PX 32; PX 32B, tab 28; (10) $20,000 paid to OTS, see PX 32; PX 32B, tab 29, (11) $107,601 paid to RP Financial, see PX 32; PX 32B, tab 33; Tr. 410:15-19 (Test. of Fuster), (12) $1,350,000 paid to R.R. Donnelly, see PX 32; PX 32B, tab 34; Tr. 524:1 to 526:12, 567:7 to 568:25 (Test. of Fuster), (13) $2,606,620 paid to Salomon Brothers, see PX 32; PX 32B, tab 35, and (14) $131,588 paid to the SEC, see PX 32; PX 32B, tab 36. Thus, the court

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Cl. at 245 nn. 8-9 (citing Fed. R. Evid. 611(a) and *United States* v. *Taylor*, 210 F.3d 311, 315 (5th Cir. 2000)).

[27] Milbank Tweed billed the banks, and the banks paid, fees and charges considerably in excess of this amount during the period from October 1993 through May 1994. However, the court has allowed only those fees and charges by Milbank Tweed that that firm specifically identified as being solely attributable to the conversion. Consequently, the court has allowed only $591,204 from a bill rendered Feb. 15, 1994, $418,338 from a bill rendered March 30, 1994, and $251,740 from a bill rendered June 14, 1994. See PX 32B, tab 23, at PX 032B-0120, 0135, 0139, and 0153.

finds that the banks incurred $9,702,982 in incidental losses related to the conversion.

In that regard, as the summation provided above shows, the court has examined the testimony at trial about the underlying documentation and has also evaluated that documentation to make determinations of fact that eliminate speculative inferences and unsupported elements of expense from plaintiffs' claimed incidental losses related to the conversion.

f. *Merger expenses.*

Lastly, the banks claim $57,764 in incidental losses related to the merger. See Tr. 407:21 to 408:13 (Test. of Fuster); PX 33 (Summary of expenses related to merger). The banks established at trial that they paid $29,700 in merger expenses to Peat Marwick, PX33; PX 32B, tab 19 at PX032B-0069, 71, 102,[28] and $10,400 to OTS in connection with the banks' merger application. See PX 33; PX 32B, tab 29, at PX32B-0222 to 225. Thus, the court finds that plaintiffs are entitled to $40,100 in incidental losses caused by merger expenses.

g. *Synopsis of incidental losses.*

The total allowed incidental losses amount to (a) $1,912,600 in excess deposit insurance (SAIF) costs, (b) $435,790 in excess OTS examination costs, (c) $571,001 in capital-plan costs, (d) $5,106,503 in

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[28] A clerical error in plaintiffs' documentation does not affect the court's determinations. Both PX 32A; tab 19 at PX032A-0088 and PX 32B, tab 19 at PX032B-0050 classify (incorrectly) a $12,500 charge from an invoice rendered by Peat Marwick as a Home Saving Sale, or branch-sale, expense. This amount should be included in the merger category of expense.

branch and associated asset-sale costs, (e) $9,702,982 in conversion expenses, and (f) $40,100 in merger expenses, for a total of $17,768,976, which rounds to $17,769,000.

5. *Tax gross-up.*

The banks request the court to award damages on a pre-tax basis, *i.e.*, to apply a "tax gross-up," to put the plaintiffs in the same position as if the breach had never occurred. Pls.' Br. at 62. The Federal Circuit has stated that "a tax gross-up is appropriate when a taxable award compensates a plaintiff for lost monies that would not have been taxable." *Home Savings IV*, 399 F.3d at 1356 (citing *Oddi* v. *Ayco Corp.*, 947 F.2d 257, 267 (7th Cir. 1991); and *First Nationwide Bank* v. *United States*, 56 Fed. Cl. 438, 449 (2003)); see also *LaSalle Talman*, 64 Fed. Cl. at 114. In this respect, some trial courts have called upon a plaintiff seeking such a gross-up to "show with reasonable certainty that the gross-up is necessary to make plaintiff whole, [that] the award will be subject to taxation and, for purposes of calculating the gross-up, that the award will be taxed at a certain rate." *Citizens Fed. Bank, FSB* v. *United States*, 59 Fed. Cl. 507, 521 (2004). The government contests plaintiffs' request, arguing that some courts have decided not to award a tax gross-up. Def.'s Br. at 81. In most such instances, trial courts found that the plaintiff failed to satisfy its burden of establishing to a reasonable certainty the need for a gross-up. See *Citizens Fed.*, 59 Fed. Cl. at 523 ("Plaintiffs are not entitled to [a tax] gross-up ... because they cannot meet their burden with reasonable certainty."); *Bank of Am.* v. *United States*, 67 Fed. Cl. 577, 597 (2005), 2005 WL 1792182, at *19

(2005)(applying the same logic as in *Citizens Federal*).

Separately, the government contends that a tax gross-up is not appropriate because the party who would receive the benefit, Astoria Financial, is not a party to the suit. Def.'s Br. at 81. Such an argument is without merit. The Federal Circuit, in *Home Savings IV*, ordered a tax gross-up despite the fact that ultimately the gross income to be taxed would be that of the plaintiffs' parent company, Washington Mutual, due to the filing of consolidated tax returns. 399 F.3d at 1356. Correspondingly here, the income to be taxed would be that of the Astoria set of entities that are the successors of Bancorp and Long Island. The government's party-related argument is accordingly unavailing.

There is reasonable certainty that a damages award for the cost of replacement capital would be necessary to make plaintiffs whole because the Federal Circuit has held that such an award compensates a plaintiff for "lost monies that would not have been taxable [i.e. the goodwill]." *Home Savings IV*, 399 F.3d at 1356; see also I.R.C. § 118 (2005) (noting that "[i]n the case of a corporation, gross income does not include any contribution to the capital of the taxpayer.").

The banks have also satisfied their burden of proving to a reasonable certainty that an actual damages award for the cost of replacement capital would be taxable. "[A]ll income" regardless of its source is taxable as gross income "unless excluded by law." Treas. Reg. § 1.61-1(a); see I.R.C. § 61(a). Without any law specifying or indicating otherwise, the banks have satisfied their burden that damages, once awarded for cost of replacement capital, would

be taxable. See *Home Savings IV*, 399 F.3d at 1356; *LaSalle Talman*, 64 Fed. Cl. at 116. Although there is a possibility that an award of this type would not be taxed, it is "not a high one" in light of the expansive language of gross income's definition under I.R.C. § 61. See *LaSalle Talman*, 64 Fed. Cl. at 116. The only type of damages award specifically excluded from gross income is one derived from a personal injury suit. See I.R.C. § 104(a)(2); see also *United States* v. *Burke*, 504 U.S. 229, 233 (1992). Therefore, it is reasonably certain that an award for cost of replacement capital would be taxed.

Finally, the banks point to evidence that a 39.6% tax rate is the most appropriate for a gross-up based on the likely tax rate for Astoria in 2004 through 2006. Tr. 1884:5 to 1885:1, see 5183:12-16 (Test. of DiConstanzo, Astoria's tax director).[29] Mr. DiConstanzo testified that Astoria's marginal tax rate for 2004 will be 39.6% and that the same figure is being budgeted for 2005 and 2006. Tr. 1884:5 to 1885:1 (Test. of DiConstanzo); see also DX 1959 (calculation of Astoria's marginal tax rate). The government argues that this tax rate for Astoria might not apply in the future because Astoria might be subject to the alternative minimum tax, and thus any projection from the plaintiffs is speculative at best. Def.'s Br. at 83-84. However, the court accepts Mr. DiConstanzo's testimony as establishing Astoria's marginal tax rate to a reasonable certainty. See also *LaSalle Talman*, 64 Fed. Cl. at 118 (rejecting the argument that an alternative minimum tax renders a tax-rate projection

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[29] Mr. DiConstanzo has served as Astoria's tax director since 1998, and he is responsible for the company's tax compliance, reporting, and planning. Tr. 1883:2-17 (Test. of DiConstanzo).

speculative). In particular, Mr. DiConstanzo testified specifically that Astoria was not subject to tax under the alternative minimum tax provisions in 2004 and was not expected to be taxed under that regime in 2005. Tr. 5183:12-16 (Test. of DiConstanzo).

In light of this evidence, the court will provide a tax gross-up to the award of damages for the cost of replacement capital at a marginal tax rate of 39.6%. The tax gross-up effectively adds $165.522 million to the award of damages. In essence, this aspect of the court's decision will require the government to pay this additional amount with one hand and take a like amount back with the other hand in the form of Astoria's tax payments for the year Astoria receives the award. If these predicted events do not actually occur, the court will be receptive to a motion under RCFC 60(b) to reopen the judgment in this case to rectify any anomaly.

CONCLUSION

Plaintiffs established at trial that the government entered into a contract with them providing for the recognition of goodwill, the use of push-down accounting, the treatment of goodwill as regulatory capital, and the amortization of goodwill over a forty-year period. This contract was breached by the government upon the enactment of FIRREA and the adoption of implementing regulations, and plaintiffs suffered loss as a consequence of that breach. The government is thus liable to plaintiffs for breach of contract.

The banks also proved damages at trial, measured by expectancy damages in the form of the cost of replacement capital plaintiffs incurred in mitigating the breach. On a basis that adjusts the

post-judgment portion of these damages for present value, such damages amount to $252,464,000. The banks also established their entitlement to incidental losses under *Restatement (Second) Contracts* § 347. Those losses amount to $17,769,000. The court also awards plaintiffs a tax gross-up for the portion of the award that consists of the cost of replacement capital, adding $165,522,000 to the award. No damages are awarded for lost profits or for reduced IPO proceeds on the conversion.

On September 30, 2005, the clerk shall enter final judgment in favor of plaintiffs, and both of them, in the amount of $435,755,000.[30] No costs.

IT IS SO ORDERED.

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[30] Final judgment for plaintiffs shall be entered on September 30, 2005, because that was the date used to calculate the present value of future damages. See *supra*, at 645. This decision is being rendered before, but sufficiently near in time to, that date such that preparation of a revised computation of present values using a slightly different date seems highly inefficient and unnecessary.

APPENDIX D
[Opinion of the United States Court of Federal Claims (Dec. 9, 2002)]

United States Court of Federal Claims.

The LONG ISLAND SAVINGS BANK, FSB, et al., Plaintiffs,

v.

The UNITED STATES, Defendant.

No. 92-517C.

Dec. 9, 2002.

OPINION

MARGOLIS, Senior Judge.

Plaintiffs brought this action against the United States contending that they had an enforceable contract with the Government to treat plaintiffs' supervisory goodwill, which was created as a result of an acquisition of a failed thrift, as regulatory capital. As regulatory capital, the plaintiffs were permitted to amortize the goodwill over a forty-year period. Plaintiffs claim that, in enacting of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989, Congress breached that contract by eliminating plaintiffs' ability to count goodwill as regulatory capital. See generally, *United States* v. *Winstar Corp.*, 518 U.S. 839 (1996).

This case is before the Court on defendant's motion for summary judgment and plaintiffs' cross-motion for summary judgment on defendant's counterclaims and affirmative defenses pursuant to United States Court of Federal Claims ("RCFC")

Rule 56. Plaintiffs' complaint states that the Government breached its contractual obligations with plaintiffs, and plaintiffs now seek compensation of $625 million in amortized goodwill regulatory capital. The Government's summary judgment motion counterclaims that: (1) plaintiffs' claims are forfeited under a special plea in fraud pursuant to 28 U.S.C. § 2514; (2) common law fraud renders the contract unenforceable; (3) the contract should be rescinded and $122 million repaid to the Government; and (4) plaintiffs' prior material breach precludes damages. This Court, pursuant to RCFC 56(g), granted additional discovery, and both parties submitted additional briefing. After oral argument, and for the reasons discussed herein, the Government's motion is denied, and plaintiffs' motion is granted.

FACTS

A. The Long Island Savings Bank and the Government's Assistance Agreement

In 1982, the Long Island Savings Bank ("LISB") was converted from a New York-chartered mutual savings bank into a federally chartered savings bank whose deposit accounts are insured by the Federal Deposit Insurance Corporation ("FDIC").[1] LISB was created as a result of the 1983 merger between the Long Island Savings Bank of Centereach, FSB ("Centereach"), and the Long Island Savings Bank of

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[1] From December 1982 through August 1989, LISB was subject to regulation and supervision by the FHLBB. Since August 1989, LISB has been subject to regulation and supervision by the Office of Thrift Supervision ("OTS"), the successor to the FHLBB, whose purpose is to maintain administrative enforcement proceedings.

Syosset, FSB ("Syosset"), both of which James J. Conway, Jr. served as Chairman and Chief Executive Officer ("CEO").

In 1983, after negotiations, the Federal Savings and Loan Insurance Corporation ("FSLIC") transferred Suffolk County Phoenix, a failing thrift franchise, to LISB, quadrupling LISB's branch network and tripling its assets to approximately $3 billion. On August 17, 1983, the FSLIC and LISB entered into an Assistance Agreement that contained restrictions pertaining to the thrift's officers and directors, and federal guidelines and regulations governing the business aspects of the new thrift.

Under the terms of the Assistance Agreement, LISB paid nothing for the franchise, but contributed $100,000 into the franchise's controlling subsidiary, Centereach. FSLIC also infused a total of $122 million into Centereach. From December 1982 until May 1992, Conway served as Board of Trustees Chairman and CEO of LISB.

B. Conway's Law Firm and his Compensation Scheme

From September 1975 until his retirement in June 1992, Conway was a partner and stockholder of Conway & Ryan PC ("the firm").[2] In 1982, Conway stopped practicing law and engaging in other professional services for the law firm. From September 1975 until December 1984, Conway owned 65% of his law firm's outstanding stock. In December 1984, Conway transferred 51% of the

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[2] In August 1985, Conway & Ryan PC changed its name to Power, Meehan & Petrelli, PC. In 1990, the firm changed its name again, this time to Power, Meehan & Power, PC.

firm's stock to his daughter, Susan C. Petrelli. Petrelli became a salaried officer and director of the firm, serving until December 1990. She did not pay her father for the stock, but rather paid the firm $51,000. Conway's daughter-in-law, Denise Whalen, was also a salaried officer and director of the firm, serving from January 1987 until December 1990. From December 1984 until January 1990, Conway's ownership interest was 9%; however, he continued to exercise control over 60% of the firm's stock. Conway retired from the firm in June 1992.

From 1982 to 1991, Conway caused LISB to utilize the firm as LISB's sole mortgage loan closing counsel, and he ensured that the firm had the exclusive right to represent LISB in connection with all mortgage closings without action from the Board of Directors. During this period, the firm collected approximately $20 million in fees from over 25,000 residential mortgage loan closings, which represented 80% to 90% of the firm's income. LISB did not pay the loan closing fees, rather the borrowers did. Of this amount, 60%-or approximately $11.3 million-was paid to Conway and his family members who worked for the firm. Conway received payments and benefits from those fees both directly from his law firm and through his daughter or daughter-in-law. Conway did not provide professional services to the firm between 1983 and 1990, but he received an annual salary and compensation from the firm during that time period.

Conway did not disclose to LISB that he was being compensated by the firm from income that the firm received for providing services to LISB. When asked by LISB whether LISB had to disclose compensation received by Conway from his firm in

an Annual Report statement,[3] Conway indicated that he received less than $500,000 annually from the firm, thereby exempting LISB from disclosure. In 1986 and 1988, the FHLBB questioned LISB regarding LISB personnel that had a direct or indirect business interest with LISB and the nature, type, and volume of those business interests. At each of those times, Conway described his relationship as retaining "an interest in a law firm that presently renders service to [LISB] and receives remuneration from outside income of said firm."

In 1990, LISB's outside counsel discovered Conway's compensation from the firm. Conway would not disclose to LISB information regarding his financial arrangements with the firm. He did indicate to LISB's counsel, however, that his compensation from the firm was part of a ten-year payout arrangement. No such arrangement actually existed. Conway attempted to enjoin LISB's outside counsel from disclosing the financial information that they had on the grounds that attorney-client privilege prohibited disclosure. In 1990, the New York trial court found that Conway made false statements about his financial arrangement with the firm to LISB's counsel and issued a gag-order regarding Conway's finances pending appeal. On March 22, 1993, the Appellate Division of the New York Supreme Court affirmed the trial court's decision. LISB incurred approximately $1 million in legal expenses as a result of this and related litigation.

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[3] In accordance with 12 C.F.R. § 563.45.

In August 2000, the Appellate Division of the Supreme Court of the State of New York, upheld the disbarment of Conway. The court determined that "while chairman of the board and chief executive officer of a savings bank, [Conway] engaged in a scheme of illegal kickbacks, using his daughter and daughter-in-law as conduits to circumvent Federal law prohibiting him from receiving compensation from his former law firm, which relied on the bank for approximately 90% of its business."

C. Office of Thrift Supervision Investigation

In March 1993, the Office of Thrift Supervision commenced an investigation into Conway's compensation scheme with the firm. In September 1993, OTS and Conway initiated settlement discussions whereby Conway agreed to pay LISB $1.3 million in restitution per issuance of a consent prohibition and cease-and-desist order, signed February 1994. The consent order banned Conway from the thrift and banking industry. In 1998, Conway pled guilty to violating 18 U.S.C. § 215.[4]

DISCUSSION

In the absence of genuine issues of material fact, this Court may award summary judgment to a party according to the law. RCFC 56(c). In reaching summary judgment, the trial court must construe facts and resolve inferences in the light most favorable to the non-movant. *Godley* v. *United States*,

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[4] 18 U.S.C. § 215 (Receipt of commissions or gifts for procuring loans) states that a director or officer commits a crime when he corruptly solicits or corruptly accepts anything of value from another person or entity intending to be rewarded in connection with any business or transaction of an insured depository institution.

5 F.3d 1473, 1474 (Fed. Cir. 1993) (citing *Adickes* v. *S.H. Kress & Co.*, 398 U.S. 144, 157 (1970)).

The Government contends that the plaintiffs' claims are forfeited in two different, but related, ways. Both deal with alleged fraudulent misrepresentations made by LISB. The Government cites a conflict-of-interest between Conway's relationship with his law firm and his relationship with LISB. Conway allegedly used his position as Chairman and CEO of LISB to make his law firm LISB's exclusive mortgage loan closing counsel and was compensated by his firm for this referral. The Government maintains that it did not know of the relationship when it entered into the Assistance Agreement with LISB and, had it known about the arrangement, it would not have entered into the Agreement.

The arrangement between Conway, his law firm, and LISB provides the Government with two possible defenses to the plaintiffs' claim. First, the Government asserts that the arrangement violated express conditions of the Agreement and that those violations served to forfeit any claims by the plaintiffs based on a Government breach of the Agreement. Second, it contends that, even if the arrangement were not a violation of the Agreement, the plaintiffs would not be able to collect upon the Agreement because the misrepresentation of the arrangement between the entities constituted fraud against the Government. Where fraud is committed against the Government, 28 U.S.C. § 2514 mandates that the claim shall be forfeited.

The essence of this case is whether Conway's improper relationship with the firm tainted the relationship LISB had with the firm. The

Government contends that because Conway was both a partner in the law firm and the CEO and Chairman of LISB, his actions, and thus this arrangement, should be imputed to LISB. Plaintiffs argue that this Court must distinguish between Conway placing himself personally in a conflicting relationship and his role in entering into the Assistance Agreement on behalf of LISB. This Court is being asked to determine whether a distinction between Conway and LISB exists. The Court will first examine whether the arrangement was a direct violation of the Assistance Agreement, then it will look at whether it constituted fraud against the Government, and, finally, it will address the issue of whether Conway's conduct in this arrangement should be imputed to LISB.

I. LISB's Representations Under the Assistance Agreement

The Government contends that LISB violated the Assistance Agreement in several ways and that those violations rendered the contract void, thereby causing the plaintiffs to be forced to forfeit any claims based on a Government breach of the Agreement. Sections 11(b)(5) and 8(h) of the Assistance Agreement include an express warranty by LISB that LISB was not in violation of any applicable statutes or regulations at the time of entering into the Agreement and a promise that LISB would remain in compliance with such statutes and regulations. The Government argues that LISB disregarded those provisions by acting in violation of the Real Estate Settlement Procedures Act ("RESPA") of 1974, § 8, as amended, 12 U.S.C. § 2607, and of 12 C.F.R. §§ 563.40 and 563.17 (1983). Plaintiffs asserts that LISB complied with all

applicable statutes and regulations and, therefore, was not in violation of the Assistance Agreement at any time. This Court will examine whether the arrangement between Conway, his law firm, and LISB caused LISB to be in violation of the Agreement.

A. Sections 11(b)(5) and 8(h) of the Assistance Agreement

In the Assistance Agreement, LISB expressly warrants both that it was not violating any statutes or regulations at the time that it entered into the Agreement and that it would continue to comply with such rules.

Section 11(b)(5) of the Agreement states that

> LISB represents and warrants that: ... LISB is not in violation of any applicable statutes, regulations or orders of, or any restrictions imposed by, the United States of America or any state, municipality or other political subdivision or any agency of the foregoing public units, regarding the conduct of its business and the ownership of its properties, including without limitation, all applicable statutes, regulations, orders and restrictions relating to savings and loan associations, equal employment opportunities, employment retirement income security, and environmental standards and controls where such violation would materially and adversely affect LISB's business, operations or condition, financial or otherwise.

Assistance Agreement § 11(b) (emphasis added).

Section 8(h) mandates that LISB will continue to be in accord with the applicable statutes and regulations:

> CENTEREACH and LISB will, and will cause any Service Corporation of CENTEREACH or LISB to, comply in all material respects with all applicable statutes, regulations and orders of, and all restrictions imposed by, the United States of America and any state municipality or other political subdivision or any agency of the foregoing public units, in respect of the ownership of its properties and conduct of its business, including, without limitation, all applicable statutes, regulations, orders and restrictions relating to equal employment opportunities, employment retirement income security and environmental standards and controls; provided, however, that nothing contained in this § 8(h) shall require CENTEREACH or LISB or any Service Corporation of CENTEREACH or LISB to comply with any law so long as the validity or applicability of such law shall be contested in good faith.

Assistance Agreement § 8(h) (emphasis added).

The Government contends that Conway's dual relationship caused LISB to violate RESPA and 12 C.F.R. §§ 563.40 and 563.17. By doing so, the Government argues that LISB acted in violation of sections 8(h) and 11(b)(5) of the Agreement, thereby causing a breach that had the effect of absolving the Government of its responsibility to perform under the Agreement.

B. Prohibitions Under RESPA, 12 U.S.C. § 2607 and 12 C.F.R. § 563.40

The Government argues that Conway's compensation scheme violated RESPA, 12 U.S.C. § 2607 and 12 C.F.R. § 563.40, thereby causing LISB to violate Sections 11(b)(5) and 8(h) of the Agreement. RESPA §§ 2601 et seq., forbids the payment of a kickback for referring to the payor an opportunity to provide a real estate settlement service for a federally related mortgage loan. RESPA § 2607 states:

> (a) Business referrals-No person shall give and no person shall accept any fee, kickback, or thing of value pursuant to any agreement or understanding, oral or otherwise, that business incident to or a part of a real estate settlement service involving a federally related mortgage loan shall be referred to any person.
>
> (b) Splitting charges-No person shall give and no person shall accept any portion, split, or percentage of any charge made or received for the rendering of a real estate settlement service in connection with a transaction involving a federally related mortgage loan other than for services actually performed.
>
> (c) Fees, salaries, compensation, or other payments-Nothing in this section shall be construed as prohibiting (1) the payment of a fee (A) to attorneys at law for services actually rendered ....

Similarly, 12 C.F.R. § 563.40, which incorporates the applicable provisions of RESPA, states:

> (a) Loan procurement fees-No affiliated person of an insured institution may receive, either directly or indirectly, from such institution, any subsidiary thereof, or any other source any fee or other compensation of any kind in connection with the procurement of any loan from such institution or subsidiary thereof.
>
> (b) Kickbacks and unearned fees-The prohibitions contained in sections 8(a) and 8(b) of the Real Estate Settlement Procedures Act of 1974 (Pub. L. 93-533) shall apply to any fee, kickback, thing of value, and any portion, split or percentage of any charge, either directly or indirectly, given to or accepted by an insured institution or subsidiary or affiliated person thereof, in connection with any loan on real property made by an insured institution or subsidiary thereof, without regard to whether the loan is within the term "federally related mortgage loan," as defined in section 3(1) of the Act.

A primary purpose of RESPA is to eliminate improper relationships that unnecessarily increase the cost of settlement services. RESPA § 2601(b)(2). There are a multitude of relationships in the banking industry that provide for legitimate compensation for services rendered; others are entered into for the purpose of eliciting kickbacks. See *e.g.*, *Lawyers Title Ins. Corp.* v. *Dearborn Title Corp.*, 118 F.3d 1157, 1162 (7th Cir. 1997) (disparity in compensation arrangement supported inference of kickback); *DeLeon* v. *Beneficial Const. Co.*, 998 F.Supp. 859, 864 (1998) (receipt of fee without providing broker

services sufficient to constitute a kickback); see also *Weil* v. *Long Island Sav. Bank*, 77 F. Supp. 2d 313, 328 (1999) (Conway's acceptance and his firm's payment of fees paid by mortgage loan borrowers violated RESPA).

C. Legal Distinctions of LISB's Relationships

Conway and his firm's impropriety under banking laws is evident. See *Weil* v. *Long Island Sav. Bank*, 77 F.Supp.2d at 328. However, the issue that underlies the Government's defense to the action brought by LISB is whether the law prohibited LISB's relationship with Conway and the firm. Helpful in this determination are the analogous comments and fact examples found in the RESPA provisions that deal with the Housing and Urban Development ("HUD"), which are essentially identical to those adopted in the banking regulations. Compare 24 C.F.R. § 3500 (1983), with 12 C.F.R. § 563.40 (1983).

The regulations that have been adopted by HUD which are associated with those RESPA provisions provide guidance in the application of the law to specific factual circumstances, and provide examples of how the provisions would apply to different factual situations. This Court, as an initial matter, will analyze the facts in this case by comparison to those situations envisioned in the regulations: Conway, a partner in the law firm, directed LISB borrowers to the law firm that provided those borrowers with mortgage closing services. The firm paid its attorneys and partners, including Conway, based on the firm's revenue from the fees charged to the borrowers. This is an analogous arrangement to one described in the regulation. See 24 C.F.R. § 3500,

App. B (Fact 10). Under the HUD regulations, while a payment to Conway from the firm would violate the regulation, the relationship between LISB and the firm would not. See *id.* (Comment 10). Thus, under RESPA § 2607 and 12 C.F.R. § 563.40, a legal distinction would be made between LISB and Conway.

Further, the facts indicate that the firm did not kickback money to LISB, rather the firm paid Conway from profits made from the borrowers. Indeed, had Conway not accepted compensation related to mortgage closing services of LISB's borrowers, but the relationship between LISB and the firm was otherwise the same, no impropriety would exist. It was not LISB's relationship with the firm that was improper. LISB was not violating RESPA or 12 C.F.R. § 563.40 and, therefore, LISB was not operating in an unsafe and unsound manner under 12 C.F.R. § 563.17. Consequently, LISB did not violate the provisions of the Assistance Agreement.

D. Applicability of 12 C.F.R. § 563.40 to LISB's "Affiliated Persons"

Under 12 C.F.R. § 561.29, Conway is considered an "'affiliated person' of an insured institution" because Conway was the CEO of LISB, see 12 C.F.R. § 561.29(a). Conway's law firm is also considered an "affiliated institution" because it was a business organization in which Conway, LISB's CEO, was a general partner, see 12 C.F.R. § 561.29(d)(2).[5]

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[5] 12 C.F.R. § 561.29 states: Affiliated person.-The term "affiliated person" of an insured institution [LISB] means the following: (a) A director, officer, or controlling person of such institution [Conway as LISB's CEO]; . . (d) Any corporation or

Defendant argues that, as Conway is an "affiliated person" of LISB, he was prohibited from accepting compensation pursuant to 12 C.F.R. § 563.40. It asserts that Conway's acceptance of such compensation created a violation of the terms of the Assistance Agreement on the part of LISB. Plaintiffs counter that 12 C.F.R. § 563.40 relates to affiliated persons receiving kickbacks in return for banks granting mortgage loans, and as LISB itself neither gave nor received kickbacks related to granting mortgage loans, 12 C.F.R. § 563.40 is inapplicable to LISB and, consequently, LISB did not violate 12 C.F.R. § 563.40.

The application of 12 C.F.R. § 563.40 to the various relationships indicates that neither Conway (as LISB's CEO) or his law firm (Conway as the firm's partner) received compensation from LISB in exchange for LISB granting a loan. Here LISB never compensated Conway or his firm for granting a mortgage loan to a borrower. Rather, the firm was compensated by LISB's borrowers for doing legitimate mortgage closing services, and Conway was then compensated by his firm. Although Conway and his firm are "affiliated persons," LISB did not receive or pay either Conway or his firm for granting loans to its borrowers. Therefore, the Court finds that Conway and his firm's status as "affiliated persons" did not cause LISB to be in violation of the Assistance Agreement.

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organization (other than the insured institution or a corporation or organization through which the insured institution operates) of which a director, officer or controlling person of such institution: ... (d)(2) Is a general partner ... [Conway's law firm]

II. Fraud

The Government contends that, even if Conway's violations of law did not a constitute a violation of the Assistance Agreement by LISB, plaintiffs' claims for recovery were nevertheless forfeited pursuant to 28 U.S.C. § 2514 because Conway, as LISB's Chairman and CEO, committed fraud upon the Government in the formation and performance of the Assistance Agreement, and that, therefore, Conway's conduct should be strictly imputed to LISB. The Court will first examine the alleged fraud and then will examine the imputation.

28 U.S.C. § 2514, Forfeiture of Fraudulent Claims, states:

> A claim against the United States shall be forfeited to the United States by any person who corruptly practices or attempts to practice any fraud against the United States in the proof, statement, establishment, or allowance thereof. In such cases the United States Court of Federal Claims shall specifically find fraud or attempt and render judgment of forfeiture.

28 U.S.C. § 2514 does not define the applicable elements of fraud. Instead, the United States Court of Federal Claims has approached the issue of fraud in forfeiture of claims cases on a case-by-case basis and has used the four common law fraud elements as a prerequisite to establishing a special plea in fraud. See *Landmark Land Co. Inc.* v. *United States*, 46 Fed. Cl. 261, 274 (2000), *aff'd in part, remanded on other grounds*, (Fed. Cir. July 24, 2001), *rehr'g and rehr'g en banc denied*, (Nov. 15, 2001); *BMY-Combat Sys. Div. of Harsco Corp.* v. *United States*, 38 Fed. Cl.

109, 128 (1997); *Colorado State Bank of Walsh* v. *United States*, 18 Cl. Ct. 611, 629-30 (1989), *aff'd*, 904 F.2d 45 (Fed. Cir. 1990). To establish the affirmative defense of fraud, the Government must, therefore, prove by clear and convincing evidence: 1) misrepresentation of a material fact; 2) knowledge and intent to deceive or a reckless state of mind; 3) justifiable reliance on the misrepresentation by the deceived party; and 4) injury to the party deceived through reliance. *J.P. Stevens & Co.* v. *Lex Tex, Ltd.*, 747 F.2d 1553, 1559 (Fed. Cir. 1984) (patent case); *Landmark Land Co., Inc.*, 46 Fed. Cl. at 274; *Colorado State Bank*, 18 Cl. Ct. at 629-30.

This Court has held that because finding fraud during the performance of a contract is not necessarily obvious and dependent on specific circumstances, the Government must prove all four elements when asserting a special plea in fraud claim to ensure that it has indeed relied on the alleged fraud and incurred a related injury. *First Federal Sav. Bank of Hegewisch* v. *United States*, 52 Fed. Cl. 774, 790-91 (2002). Otherwise, the Government would be able to avoid legitimate contractual claims against it by simply pointing to unrelated events that occurred during the performance of the contract that resulted in no harm to the Government. *Id.* This is unlike fraud committed in the presentation of a claim where the reliance and harm is inherent since it is the claim itself that is fraudulent. *Id.* Thus, this Court can concurrently analyze the Government's 28 U.S.C. § 2514 and common law fraud arguments.

This Court has applied two different lines of cases defining a special plea in fraud, both of which have been supported by the Federal Circuit. As

discussed above, the first line of cases define a special plea in fraud as containing the same elements of proof as common law fraud: misrepresentation of fact, knowledge, reliance, and injury. The second line of cases ascribes to the special plea in fraud only two elements: knowledge and intent to deceive. See *Glendale Federal Bank, FSB* v. *United States*, 239 F.3d 1374, 1379 (Fed. Cir. 2001) (citing *Commercial Contractors, Inc.* v. *United States*, 154 F.3d 1357, 1362 (Fed. Cir. 1998)); *Young-Montenay, Inc.* v. *United States*, 15 F.3d 1040, 1042 (Fed. Cir. 1994) (citing *McCarthy* v. *United States*, 229 Ct. Cl. 361, 670 F.2d 996, 1004 (1982)); *Supermex, Inc.* v. *United States*, 35 Fed. Cl. 29, 42 (Fed. Cl. 1996) (Court stated it was unclear whether two or four elements were required to prove fraud, but only two were needed in that case). Because this Court ultimately finds that the Government has not established elements common to both lines of analysis, the Government's special plea in fraud fails under both.

1. Misrepresentation of Fact

The Government must first prove that there has been a misrepresentation of material fact. As Chairman and CEO of LISB, Conway had the authority to enter into the Assistance Agreement. Conway did so knowing his conflicting dual relationship with his firm and LISB prohibited him from entering into the Assistance Agreement and from receiving compensation from his firm. The State of New York courts determined that if Conway were not LISB Chairman and CEO, he and the firm would not have been able to "engage [ ] in a scheme of illegal kickbacks, ... circumvent[ing] Federal law prohibiting him from receiving compensation from

his former law firm, which relied on the bank for approximately 90% of its business." The evidence shows that the perpetrators of the scheme, Conway and his firm, misrepresented information and benefited from Conway's arrangement, whereas LISB received no improper benefit from Conway's conflict. Indeed, LISB's independent efforts to disclose Conway's scheme support the conclusion that, had LISB known of Conway's conflict-of-interest, it is unlikely that LISB would have permitted Conway from misrepresenting his personal compensation scheme.

2. Knowledge of Misrepresentation

The Government contends LISB had knowledge of Conway's compensation scheme; however, it also claims that, even if it were found that LISB did not have knowledge, LISB's lack of knowledge would be irrelevant because Conway's conduct is strictly imputed to LISB. Although this Court will address the issue of imputation below, for the purpose of determining whether LISB committed fraud in connection with the Assistance Agreement, this Court finds that the LISB's knowledge of a misrepresentation is pertinent in understanding the circumstances under which the allegations of fraud are being made.

It was not until almost nine years into the performance of the Assistance Agreement that LISB's outside counsel discovered the conflict-of-interest and, upon doing so, questioned Conway regarding his relationship with the firm. Conway made misrepresentations to LISB to conceal his conflict-of-interest by telling outside counsel that his compensation from the firm was part of a ten-year payout arrangement and then refusing to disclose

information regarding his financial arrangements with the firm. When LISB attempted to rectify Conway's fraud, Conway attempted to enjoin LISB from disclosing his finances. LISB incurred approximately $1 million in legal expenses derived from this and related litigation. But for LISB's attempt to have Conway disclose his conflict-of-interest, the Government might still be unaware of its existence.

The Government points to statements of LISB executives to establish that others in LISB knew of Conway's compensation arrangement at the time LISB entered into the Assistance Agreement:

> Q: Do you know if the members of the board at that time knew that you had an interest in the law firm?
>
> ...
>
> A: ... The only ones I can absolutely be sure of would be Mr. Viklund [who signed the management questionnaires that showed Conway retaining an interest in the law firm] and Mr. Buxton [who handled the law firm's insurance]....

Aug. 17, 2000 Deposition of James J. Conway, Jr., at 182.

> Q: Do you think Mr. Conway should have told the board he was receiving nearly $500,000 from the law firm?
>
> A: I think he informed everybody.
>
> Q: You were aware of that as a member of the board?
>
> A: Yes.

Sept. 29, 2000 Deposition of Edwin M. Canuso, at 78.

> Q: Do you know how much of this million dollars that [Conway's daughter and daughter-in-law] made occasionally came from business with the bank?
>
> A: I assume. The law firm was doing most of its business with the bank. I'm assuming that's where the money came from.
>
> Q: Do you think Conway should have told the board that his [daughter and daughter-in-law] were earning so much money based on business with the law firm and the bank?
>
> A: It was their business. I mean, I can't say that it was their responsibility to let us know how much money they were making.

Sept. 29, 2000 Deposition of Edwin M. Canuso, at 84-85.

While these statement show LISB knew that Conway was receiving compensation from his firm, these statements do not establish that others in LISB knew that Conway's firm compensation was improper. Rather, these same LISB executives indicate that they were unaware of any impropriety.

> Q: Based on the information that you've just read now in various documents, do you believe that Mr. Conway kept the board properly apprized (sic) of his activities or should he have given you more information?
>
> A: We were apprized (sic) properly. Whether or not it was correct or not, how can we judge? I mean, we received the documentation accordingly and we accepted it on face value.

...

Q: Do you believe there's any information Mr. Conway kept from the board that he should have disclosed?

A: I wouldn't know that.

Sept. 29, 2000 Deposition of Edwin M. Canuso, at 76-77.

Q: Did the board of directors ever ask Conway about his interest in the law firm?

A: To my knowledge, no.

Q: Do you know why not?

A: It was just the accepted practice.

...

Q: If Mr. Conway was receiving income from the law firm directly related to the services the firm was providing for the bank, would that create a conflict-of-interest? ...

A: No.

Oct. 25, 2000 Deposition of George Irvin, at 41-43.

Although LISB knew Conway was being compensated by his firm, this Court cannot conclude that LISB knew that the arrangement was improper, and, therefore, a misrepresentation. Also, the extent to which Conway acted to conceal his conflict from LISB once LISB discovered Conway's compensation arrangement is significant in establishing LISB's knowledge of the impropriety of Conway's compensation. The Government has not established that LISB's knowledge of Conway's compensation equates to LISB's knowledge of a misrepresentation.

3. Justifiable Reliance

A primary function and purpose of the laws and agencies responsible for regulating the banking industry is to ensure the safe and sound management of banks and the money the public entrusts to banks. Not only is this generally apparent within the law, but within the Assistance Agreement. The Government contracted for full disclosure of any conflicts-of-interest in order to assure the safe and sound management of LISB, and it relied on Conway's statements. The Government thus justifiably relied on Conway's misrepresentation.

It is further apparent that LISB also relied on Conway to disclose his conflict. Indeed, without the action of LISB, there is no evidence that the Government would have independently discovered Conway's conflict-of-interest. What is clear is that, for Conway to have benefited from his scheme, he needed both the Government and LISB to rely on his deception.

4. Injury

It is sufficient that the "injury and the damages to the sovereign are presumed in the breach of the bond of public trust." *Supermex, Inc.* v. *United States*, 35 Fed. Cl. 29, 42 (Fed. Cl. 1996) (bribing public officials is an inherent public harm). However, it is difficult for the Court to accept the Government's contention that plaintiffs' conduct caused injury to the public's trust in banks, particularly when the Government continued to accept LISB's performance under the contract.

The alleged public injury is questionable because the party that appears to have been actually injured

is LISB, which spent over $1 million in litigation resolving issues surrounding Conway's misconduct. Further, LISB fully performed its obligations under the Assistance Agreement, and the Government sustained no cognizable injury. This is not a case of conspiracy for corporate benefit, but of concealed misstatements for personal gain.

Conway could arrange his scheme only as someone who was authorized to enter into the Assistance Agreement with the Government; however, it would be incorrect to characterize his personal compensation scheme as being authorized by LISB. As LISB's Chairman and CEO, Conway had this authority and acted on behalf of LISB; however, his fraud was not based on the Agreement; rather, the fraud resulted from his compensation arrangement with the firm. Forfeiture of Fraudulent Claims Act, 28 U.S.C. § 2514, was not intended to forfeit an otherwise valid claim merely because in some other unrelated transaction a person defrauds the Government; rather, it was intended to apply to situations where fraud was committed with regard to the very contract upon which the suit is brought. See *Little* v. *United States*, 138 Ct. Cl. 773, 778, 152 F.Supp. 84 (1957). Conway's improper compensation relationship with his firm was not related to the Assistance Agreement, and, therefore, to forfeit LISB's claim due to that scheme would not serve to carry out the intentions of the Forfeiture of Fraudulent Claims Act.

Conway used his authority independently and without LISB's knowledge to gain personally from his dual relationship. The Government has not submitted sufficient evidence that other members of LISB knew of Conway's conflict and his

compensation scheme to provide a material genuine issue of fact. Conway did so without LISB's knowledge and approval, as evidenced by his concealment of this information from LISB and by LISB's litigation with Conway over disclosure of his compensation. Because the compensation that Conway received from the firm placed LISB in unknowing liability, LISB essentially was used by its own agent, Conway, for his personal gain and not for corporate benefit. See *Acme Process Equip. Co.* v. *United States*, 171 Ct. Cl. 324, 347 F.2d 509, 519 n. 12 (1965), *rev'd on other grounds*.

The Court therefore cannot conclude that LISB, as a corporate entity, acted fraudulently. Thus, the question remains whether Conway's conduct alone can be imputed to LISB.

III. Imputation of Conway's Conduct to LISB

A corporation can act only through its officers and agents and, when they are clothed with the authority to act for it, the corporation is responsible for their acts. *Wagner Iron Works* v. *United States*, 146 Ct. Cl. 334, 174 F.Supp. 956, 958 (1959) (citing *Gleason* v. *Seaboard Air Line Ry. Co.*, 278 U.S. 349, (1929); *Standard Surety & Cas. Co. of New York* v. *Plantsville Nat. Bank*, 158 F.2d 422 (2nd Cir. 1946); *Ralston Purina Co.* v. *Novak*, 111 F.2d 631 (8th Cir. 1940)). Under general rules of agency law, principals are liable even when their agents act fraudulently so long as they are acting with apparent authority. See *American Soc. of Mechanical Engineers, Inc.* v. *Hydrolevel Corp.*, 456 U.S. 556, 565-66 (1982); *Anderson* v. *United States*, 47 Fed. Cl. 438, 448 (2000). For instance, a principal is liable for an agent's fraud, though the agent acts solely to benefit himself, if the agent acts with apparent authority.

See *O'Brien Gear & Mach. Co.* v. *United States*, 219 Ct. Cl. 187, 591 F.2d 666, 672 (1979) (fraud of the plaintiff's president, chief executive officer, and the sole owner of the corporate stock imputed to plaintiff corporation).

Imputation of fraud is not, however, automatic. Under the law of imputation, courts impute the fraud of an officer to a corporation only when the officer commits the fraud (1) in the course of his employment, and (2) for the benefit of the corporation. *First Federal Sav. Bank of Hegewisch*, 52 Fed. Cl. at 792; see *Official Committee of Unsecured Creditors* v. *R.F. Lafferty & Co., Inc.*, 267 F.3d 340, 358-59 (3rd Cir. 2001). Thus, imputation of an agent's actions to his principal is precluded where the agent's actions are taken for the purpose of defrauding the principal. *Trilon Educational Corp.* v. *United States*, 217 Ct. Cl. 266, 578 F.2d 1356, 1361 (1978) (noting that an individual's criminal conviction of fraud on an unrelated contract bid that resulted in debarment need not inevitably be imputed to an affiliated firm). Thus, for there to be strict imputation, the Government must establish that indeed the perpetrator of the fraud acted on behalf of the corporate entity, and not merely for his own personal benefit.

For purposes of imputation, the important distinction is not between LISB and Conway, rather it is between Conway's duties as CEO and Chairman versus his individual conduct. Apparent authority is defined as when a "principal permits the agent to exercise or which he holds [the agent] out as possessing." *Strann* v. *United States*, 2 Cl. Ct. 782, 789 (1983) (quoting S. Williston, A Treatise on the Law of Contracts §§ 277, n. 11 (W. Jaeger 3d ed.

1959 and 1982 Supp.); citing Restatement (Second) of Agency § 8 (1958)). Determining whether apparent authority exists requires scrutiny into the principal's behavior in the relationship with its agent. *Strann*, 2 Cl. Ct. at 789.

As LISB's CEO and Chairman, it would appear that, in entering into the Assistance Agreement, Conway acted within the scope of his employment. However, the circumstances here show that, once LISB became aware of Conway's compensation scheme, LISB acted to disclose Conway's compensation and Conway fought to prevent LISB from disclosing that information. LISB's independent efforts to disclose Conway's compensation scheme and Conway's efforts to rebuff LISB's efforts weigh heavily in supporting the conclusion that Conway's personal compensation scheme was not authorized by LISB.

It is undisputed that Conway, as LISB's CEO and Chairman, had the authority to enter into the Assistance Agreement on behalf of LISB. It cannot be said, however, that LISB authorized or approved Conway's personal compensation scheme with the firm. The fraud here was not in entering into the Assistance Agreement, rather the fraud the Government challenges is with regard to Conway's compensation scheme, an arrangement that was neither found within the scope of Conway's duties as LISB's CEO and Chairman nor approved of by LISB. When an agent's motive and conduct demonstrate that he has abandoned his principal's interest and is acting to defraud his principal, entirely for his own or another's purpose, his knowledge and misconduct will not be imputed to his principal. *Acme Process Equip. Co.* v. *United States*, 347 F.2d at 519 n. 12.

The rationale for this exception is clear in that the law presumes that the wrongdoer would not perform his usual duty to disclose all material facts regarding his action if such disclosure would reveal the fraud that he committed. This is evidenced by the fact that, had the knowledge that the Government seeks to impute to LISB actually been disclosed to LISB, the success of Conway's scheme would have been impaired.

The second part of the imputation test is whether the fraudulent conduct was perpetrated for the benefit of LISB. *Official Committee of Unsecured Creditors*, 267 F.3d at 359. Under this prong, fraudulent conduct will not be imputed if the officer's interests were adverse to the corporation and not for the benefit of the corporation. *Id.*; *First Federal Sav. Bank of Hegewisch*, 52 Fed. Cl. at 792-93 (adopting the adverse interest exception); see *Crocker* v. *United States*, 49 Ct. Cl. 85, 1913 WL 1286 (1913) (where an agent goes beyond the scope of his authority and commits a wrong or fraud to accomplish a purpose designedly his own, the principal is not liable).

The Government has not established that LISB benefited, monetarily or otherwise, from Conway's misrepresentation. Only Conway received compensation from his firm. LISB did not pay the loan closing fees or provide the firm with payment, rather the individual borrowers did. There is no evidence that LISB as a corporate entity or that LISB's officers (other than Conway) received compensation under Conway's scheme. The fraud benefited only Conway, his family, and his law firm; it did not benefit LISB.

Because this Court finds that the Assistance Agreement was not actually tainted by illegality or

impropriety, that is, that the Agreement was used a tool of an independent conflict-of-interest, rather than the actual product of the conflict, the Court finds that the Agreement is not void *ab initio*. *Godley* v. *United States*, 5 F.3d at 1475 n. 1 (noting that although the court in *K & R Engineering Co.* v. *United States*, 222 Ct.Cl. 340, 616 F.2d 469 (1980), misread the factual predicate of *United States* v. *Mississippi Valley Generating Co.*, 364 U.S. 520, 565 (1961), it was correct in that, for a contract to be void *ab initio*, the contract must be the actual product of the conflict-of-interest, not an agreement entered into separately from the conflict-of-interest, or condoned by the company whose agent acts with its authority). Here, plaintiffs took action to uncover Conway's conflict-of-interest. Likewise, the Government's assertion that the Agreement is void or voidable because of Conway's misrepresentations is also inapposite because Conway's personal misconduct does not render the Agreement void or voidable. LISB was innocent of the misconduct and complied with banking regulations, and thus, LISB committed no fraud under the Agreement's terms. Lastly, because the contract itself is not tainted by Conway's conflict-of-interest, and has remained pure in formation and performance, rescission would be improper. See *Nebco* v. *United States*, 23 Cl. Ct. 635, 642 (1991).

CONCLUSION

For the reasons stated herein, plaintiffs' motion for summary judgment regarding defendant's fraud counterclaims and defenses is granted. Defendant's motion for summary judgment is denied.

APPENDIX E
[Order of the United States Court of Appeals For The Federal Circuit (Dec. 28, 2007)]

UNITED STATES COURT OF APPEALS FOR THE FEDERAL CIRCUIT

2006-5029

THE LONG ISLAND SAVINGS BANK, FSB, and THE LONG ISLAND SAVINGS BANK OF CENTEREACH FSB,

Plaintiffs-Appellees,

v.

UNITED STATES,

Defendant-Appellant.

ORDER

UNITED STATES COURT OF APPEALS FOR THE FEDERAL CIRCUIT

ORDER

A combined petition for panel rehearing and for rehearing en banc having been filed by the Appellees, and a response thereto having been invited by the court and filed by the Appellant*, and the petition for rehearing and response, having been referred to the panel that heard the appeal, and thereafter the petition for rehearing en banc and response having been referred to the circuit judges who are in regular active service,

UPON CONSIDERATION THEREOF, it is

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* A brief was also filed by The National Defense Industrial Association as amicus curiae.

ORDERED that the petition for panel rehearing be, and the same hereby is, DENIED and it is further

ORDERED that the petition for rehearing en banc be, and the same hereby is, DENIED.

The mandate of the court will issue on January 4, 2008.

FOR THE
COURT,
Jan Horbaly
Clerk

Dated: 12/28/2007

cc: Jeanne E. Davidson
William E. Wallace, III
W. Bruce Shirk

LONG ISLAND SAVINGS V US, 2006-5029
(CFC - 92-CV-517)

APPENDIX F

[*En Banc* Order of the United States Court of Appeals For the Federal Circuit (Sept. 18, 2007)]

United States Court of Appeals for the Federal Circuit

2006-5029

THE LONG ISLAND SAVINGS BANK, FSB,

and THE LONG ISLAND SAVINGS BANK OF CENTEREACH FSB,

Plaintiffs-Appellees,

v.

UNITED STATES,

Defendant-Appellant.

ON PETITION FOR PANEL REHEARING AND REHEARING EN BANC

Before MICHEL, Chief Judge, NEWMAN, MAYER, LOURIE, RADER, SCHALL, BRYSON, GAJARSA, LINN, DYK, PROST, and MOORE, Circuit Judges.

ORDER

The Appellees filed a combined petition for panel rehearing and rehearing en banc, and the court invited the Appellant to file a response thereto. The petition for panel rehearing was referred to the panel that heard the appeal, and thereafter the petition for rehearing en banc and response were referred to the circuit judges who are in regular active service. A poll was requested and taken.

Upon consideration thereof,

IT IS ORDERED THAT:

(1) The petition for rehearing was denied.

(2) The petition for rehearing en banc was granted for the limited purpose of returning the case to the merits panel.

FOR THE COURT

_____ _____

Date Jan Horbaly
Clerk

cc: William E.
Wallace, Ill, Esq.
Jeanne E. Davidson,
Esq.

(4)

FILED

JUN 25 2008

No. 07-1234

In the Supreme Court of the United States

THE LONG ISLAND SAVINGS BANK, FSB, ET AL.,
PETITIONERS

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FEDERAL CIRCUIT

BRIEF FOR THE UNITED STATES IN OPPOSITION

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QUESTIONS PRESENTED

1. Whether the court of appeals correctly held that petitioners' fraud rendered their contract with the United States unenforceable.

2. Whether the court of appeals correctly held that petitioners' prior material breach of the contract precluded their claims.

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In the Supreme Court of the United States

No. 07-1234

THE LONG ISLAND SAVINGS BANK, FSB, ET AL.,
PETITIONERS

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FEDERAL CIRCUIT

BRIEF FOR THE UNITED STATES IN OPPOSITION

OPINIONS BELOW

The opinions of the court of appeals (Pet. App. 1a-37a, 38a-68a) are reported at 503 F.3d 1234, and 476 F.3d 917, respectively. The opinions of the Court of Federal Claims (Pet. App. 69a-169a, 170a-198a) are reported at 67 Fed. Cl. 616, and 54 Fed. Cl. 607, respectively.

JURISDICTION

The judgment of the court of appeals was entered on September 13, 2007. The petitions for rehearing were denied on December 28, 2007 (Pet. App. 199a-200a, 201a-202a). The petition for a writ of certiorari was filed on March 27, 2008. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

This is one of the breach-of-contract cases that were filed after the enactment of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA), Pub. L. No. 101-73, 103 Stat. 183. See *United States* v. *Winstar Corp.*, 518 U.S. 839 (1996) (*Winstar*). Of the approximately 122 *Winstar*-related cases that were originally filed, only approximately 17 remain pending, and most of those cases, like this one, have nearly completed the litigation process.

1. a. Petitioners are the Long Island Savings Bank, FSB (LISB) and the Long Island Savings Bank of Centereach FSB (Centereach). This case arises from LISB's acquisition of Centereach, a federally insured thrift that had been created by the government's merger of two troubled thrifts by the Federal Savings and Loan Insurance Corporation (FSLIC). Pet. App. 2a, 72a-73a.

In connection with the acquisition, LISB, Centereach, and FSLIC entered into an Assistance Agreement in 1983. Pursuant to the Assistance Agreement, LISB acquired Centereach as a wholly-owned subsidiary by purchasing 100% of Centereach's stock for $100,000. The Assistance Agreement required FSLIC to make infusion of cash to Centereach that totaled $122 million. Pet. App. 3a, 76a-77a, 172a. The Assistance Agreement also permitted Centereach to account for $625.4 million of goodwill to be amortized over 40 years. *Id.* at 3a, 76a. LISB thereafter was able to dramatically expand its asset size, "increas[ing] its branch network fourfold, from twelve to forty-eight branches, and * * * its assets more than threefold, from approximately $1.2 billion to $4.1 billion." *Id.* at 80a.

The soundness and integrity of LISB's management were critical to the government's decision to enter into

the Assistance Agreement. Pet. App. 3a. The Assistance Agreement thus provided, as a condition precedent to FSLIC's entering into the transaction, that the Chairman of the Board of LISB certify that it was being operated in a safe and sound manner with no violations of federal statutes or regulations that could materially and adversely affect the operations or condition of the bank. Specifically, Section 2(c)(7) of the Agreement required a certification that LISB's "representations and warranties * * * set forth in § 11(b) are true and substantially correct as of the Purchase Date [August 17, 1983]" and that "[n]o event has occurred and is continuing on the Purchase Date which would constitute * * * a Breach." *Id.* at 3a-4a. Section 11(b)(5) of the Agreement in turn provided that:

> *LISB is not in violation of any applicable statutes, regulations* or orders of, or any restrictions imposed by, the United States of America * * * regarding the conduct of its business * * *, including, without limitation, all applicable statutes, regulations, orders and restrictions relating to savings and loan associations * * * where such violation would materially and adversely affect LISB's business, operations or condition, financial or otherwise.

Id. at 4a-5a. LISB also represented and warranted in Section 11(b)(9) that it would not make "any untrue statement of a material fact or omit to state a material fact necessary to be stated in order to make the statements contained therein not misleading," and that the Assistance Agreement contained every fact materially adversely affecting LISB. *Id.* at 5a.

When LISB acquired Centereach, regulations required LISB to maintain safe and sound management,

including by complying with the Real Estate Settlement Procedures Act of 1974, (RESPA), 12 U.S.C. 2601 *et seq.* 12 C.F.R. 563.17, 571.7 (1983). Regulations of the Federal Home Loan Bank Board also prohibited directors and officers of insured institutions from receiving fees, kickbacks, or anything of value, directly or indirectly, in connection with any institution loan for real property. 12 C.F.R. 563.40 (1983).

At the time of contract formation, LISB's Chairman of the Board and Chief Executive Officer (CEO), James Conway (Conway), signed the required certification of the Assistance Agreement. Pet. App. 5a. That certification was false, as Conway at the time was involved in an illegal kickback scheme related to fees associated with LISB's real-estate loan closings. *Id.* at 12a-14a, 22a-26a, 187a-188a. Pursuant to that scheme, all of LISB's loan closings were directed to a law firm controlled by Conway. Although he did not practice law, the firm kicked back millions of dollars to Conway, either directly or through family members who Conway placed at the firm. *Id.* at 6a-7a, 12a-14a, 22a-26a. Conway also repeatedly misrepresented his relationship with the law firm in a series of questionnaires the banks submitted to regulators during the 1980s. *Id.* at 7a-9a, 173a-174a.

b. In August 1989, Congress enacted FIRREA to address widespread problems in the savings and loan industry. FIRREA created the Office of Thrift Supervision (OTS) and charged it with examining, supervising, and regulating federally insured thrifts. 12 U.S.C. 1462a, 1463. FIRREA also imposed new capital requirements on thrifts and restricted their ability to count goodwill toward those capital requirements. Pet. App. 10a. FIRREA thus restricted Centereach's ability to count its $625 million in goodwill toward regulatory cap-

ital requirements and altered the period over which LISB could amortize its goodwill.

c. After the enactment of FIRREA, Conway hired an outside law firm to advise the banks. In the course of that representation, the law firm discovered Conway's compensation arrangement with his former firm. Petitioners thereafter disclosed Conway's arrangement to OTS, which in turn banned Conway from holding any position in an insured financial institution. Pet. App. 10a-12a. In February 1998, Conway pleaded guilty to a criminal violation of 18 U.S.C. 215, admitting that he "knowingly, intentionally and corruptly solicit[ed], demanded, accepted and agreed to accept . . . funds from the law firm paid directly to him, . . . intending to be influenced and rewarded in connection with . . . the assignment of the LISB residential mortgage closing work to the law firm." Pet. App. 13a (brackets in original). Conway was also disbarred by the New York Supreme Court, which found that he "engaged in a scheme of illegal kickbacks, using his daughter and daughter-in-law as conduits to circumvent Federal law prohibiting him from receiving compensation from his former law firm." *Id.* at 13a-14a (quoting *In re Conway*, 712 N.Y.S.2d 610, 611 (App. Div. 2000)).

2. Meanwhile, in August 1992, petitioners filed this suit in the Court of Federal Claims, alleging that, by enacting FIRREA, the government breached the Assistance Agreement's provision stating that LISB could count the goodwill created by its acquisition of Centereach toward its regulatory capital computations. Pet. App. 12a. In February 2001, the government filed its answer, including its counterclaims and defenses, based upon petitioners' fraud and prior material breach of the contract. *Id.* at 14a. Defendant's answer was filed pur-

suant to the schedule agreed upon by the parties and set forth in the case management order governing this and other *Winstar*-related actions, which expressly stated that "no defenses or arguments of any kind should be deemed waived" because the answer had not been filed previously. *Ibid.*

3. The Court of Federal Claims denied the government's summary judgment motion with respect to the counterclaim for fraud and its defense of prior material breach. Pet. App. 170a-198a. The trial court recognized that Conway had engaged in an illegal scheme to receive kickbacks from his law firm with respect to LISB loan closings. *Id.* at 172a-175a. The court nonetheless rejected the fraud counterclaims based on its conclusions that LISB itself had not acted fraudulently and that Conway's conduct could not be imputed to LISB. *Id.* at 194a-198a. The trial court further found that LISB had not committed a prior material breach of the Assistance Agreement. *Id.* at 177a-184a. In reaching that conclusion, the trial court held that LISB did not violate RESPA because it did not pay the kickback charges to Conway; rather, Conway's law firm paid the kickbacks. *Id.* at 183a. The trial court then reasoned that, because LISB was not violating RESPA, LISB was not operating in an unsafe and unsound manner, and therefore did not violate the Assistance Agreement's warranty and disclosure provisions. *Ibid.*

The government subsequently moved for summary judgment seeking to dismiss petitioners' claims for $474 million in restitution damages. The trial court granted the government's motion, holding that petitioners' claim was "both speculative and indeterminate." 60 Fed. Cl. at 96 (quoting *Glendale Fed. Bank FSB* v. *United States*, 239 F.3d 1374, 1382 (Fed. Cir. 2001)).

Following a trial, the Court of Federal Claims issued its decision holding the government liable for breach of the Assistance Agreement. Pet. App. 107a-120a. The court awarded petitioners expectancy damages of more than $252 million, incidental damages of almost $18 million, and a tax gross-up of more than $165 million, for a total of approximately $435 million. *Id.* at 168a-169a.

4. The court of appeals reversed, holding that petitioners' claims were forfeited under the special plea in fraud statute, 28 U.S.C. 2514. Pet. App. 38a-68a. Following petitioners' petition for panel rehearing and rehearing en banc, the court of appeals, acting en banc, returned the case to the panel, which withdrew and vacated its original opinion. *Id.* at 2a. The court of appeals then held that the trial court erred in denying the government's summary judgment based upon fraud and prior material breach. *Id.* at 1a-37a.

The court of appeals observed that, pursuant to the Restatement (Second) of Contracts § 163 (1981) (Restatement), a misrepresentation may prevent the formation of contract, thus making the contract void. Pet. App. 19a-20a. The court of appeals then recognized that "the general rule is that a Government contract tainted by fraud or wrongdoing is void *ab initio*." *Id.* at 20a (quoting *Godley* v. *United States*, 5 F.3d 1473, 1476 (Fed. Cir. 1993)). The court held that rule was satisfied here because LISB obtained the contract by knowingly making a false statement that LISB was operating in a safe and sound manner at the time of the Centereach acquisition. *Id.* at 21a-24a. The court of appeals further held that Conway's knowledge of the certification's falsity should be imputed to LISB. *Id.* at 26a-29a. The court of appeals explained that Conway's arrangement to funnel LISB's mortgage closing transactions to his

law firm benefitted LISB because it obtained the legal services required for the closings, *id.* at 28a-29a, and because "by signing the false certification under the Assistance Agreement, Conway enabled LISB to acquire Centereach," *id.* at 29a. The court of appeals further found that the government had "contracted for full disclosure of any conflicts-of-interest in order to assure the safe and sound management of LISB," and had justifiably relied upon Conway's misrepresentations. *Id.* at 29a-30a. The court of appeals explained that "the only reasonable inference is that had [petitioners] stated the truth about Conway, they would not have received the contract." *Id.* at 31a.

The court of appeals further held that, "[e]ven if the contract were not void, the doctrine of prior material breach precludes [petitioners'] breach of contract claim for damages." Pet. App. 31a. The court of appeals concluded that "because the Assistance Agreement explicitly conditioned the government's obligations" upon the "representations and warranties of LISB set forth in § 11(b)" of the Assistance Agreement, "the falsity of LISB's certification * * * represents a failure of performance." *Id.* at 32a-33a. The court of appeals explained that petitioners' failure of performance was material because, without the false certification, petitioners would not have received the contract. *Id.* at 33a. The court of appeals similarly determined that, because the government relied upon the certification, LISB's failure of performance preceded the government's breach and was never cured. *Ibid.* The court of appeals accordingly concluded that "LISB's false certification constitutes an uncured material failure of performance that provides

an independent basis for precluding [petitioners'] claim for damages." *Id.* at 36a.[1]

ARGUMENT

The court of appeals correctly held that petitioners' knowingly made false material statements, both at the formation of the contract with the United States, and during the contract's performance, preclude petitioners' breach of contract claim. That fact-bound decision does not warrant further review by this Court.

1. Petitioners contend (Pet. 16-24) that the court of appeals erred by failing to hold that petitioners' fraud in inducing the Assistance Agreement merely rendered that contract voidable, and not, as the court of appeals held, void ab initio. Petitioners thus argue that the court of appeals' decision conflicts with precedents of this Court recognizing the distinction between the two concepts and that the court "did not attempt to reconcile its holding with generally applicable principles of contract law, and did not rely for its rule on the Restatement or the decisions of any other court." Pet. 19; see Pet. 23-24. That contention is incorrect and would not warrant this Court's review in any event.

a. Contrary to petitioners' statement (Pet. 16-17) the court of appeals cited the Restatement §§ 163-164, and expressly recognized that "a misrepresentation may prevent the formation of a contract or may make a con-

[1] The court of appeals did not address the government's challenges to the trial court's award of damages. The government argued that any costs resulting from the merger were not caused by the breach; that the merger entailed no new capital costs; that the trial court erred in imputing costs to LISB's contributed capital; that the trial court used an improper methodology for calculating any imputed costs of LISB's retained earnings; and that the trial court erred by awarding tax gross-up damages. Gov't C.A. Br. 36-62.

tract voidable." Pet. App. 19a. Section 163 states that, if a misrepresentation concerns an essential term of the contract, so that the opposing party does not have a reasonable opportunity to know of the character or the essential terms of the contract, "there is no effective manifestation of assent and no contract at all." Restatement § 163 cmt. a.

The court of appeals correctly determined in this case that LISB's representations that it was operating in a safe and sound manner and that it had not failed to disclose material information were essential terms of the contract. Pet. App. 30a-33a. The fraud here thus "relates to the very nature of the proposed contract itself." Restatement § 163 cmt. a.

Through the Assistance Agreement, the government contracted primarily for LISB's safe and sound management, an essential concern of the government, given that Centereach's financial condition was deteriorating and its acquisition was funded from the outset by $75 million of government-infused cash, with the government's assistance totally $122 million. The government's concern for safe and sound management was further based upon its desire to maintain the public's trust in the banking system, a trust that depends to a large degree on the integrity of bank management. A meeting of the minds as to the integrity and truthfulness of LISB's representations was therefore essential—and a condition precedent—to any agreement by the government with the petitioners. Pet. App. 3a-4a.

The evidence was uncontested that there would have been no contract if the government had known that the certification—a central tenet of the contract itself—was false and if petitioners instead had truthfully set forth the facts concerning the safety and soundness of LISB's

management. Pet. App. 9a-10a, 30a-31a. Accordingly, there was no effective manifestation of assent by the government to the essential terms of the contract concerning safety and soundness of LISB's management. In other words, petitioners understood that the contract itself actually did not set forth true and accurate representations concerning safety and soundness and full disclosure of material facts, while the government understood the contract's essential terms as setting forth truthful representations concerning these matters.

b. Petitioners also contend (Pet. 19-23) that the court of appeals' finding that the Assistance Agreement was void ab initio conflicts with *United States ex rel. Siewick* v. *Jamieson Science & Engineering, Inc.*, 214 F.3d 1372, 1377 (D.C. Cir. 2000) (*Jamieson*), and *Hayes International Corp.* v. *McLucas*, 509 F.2d 247, 263 n.26 (5th Cir.), cert. denied, 423 U.S. 864 (1975). That is not correct, as those decisions are clearly distinguishable from the court of appeals' decision in this case. *Jamieson* was a qui tam action in which the United States was not a party, and the court addressed the distinction between void and voidable contracts only in what is essential dictum, as the court of appeals concluded that the relator had not shown that the government was defrauded. 214 F.3d at 1376-1378. Moreover, *Jamieson* acknowledged that "contracts that are seen as being in fundamental violation of public policy" are void (rather than merely voidable). *Id.* at 1377. *Jamieson* did not involve conduct remotely resembling that at issue here, where petitioners made an express certification in the contract that was both essential to contract formation and false.

Hayes is even further removed from this case. That case did not even discuss the difference between con-

tracts that are void and those that are voidable. The court, in a concluding footnote, merely declined to invalidate a government contract based on an asserted "general public policy against conflicts of interest," unanchored to specific penal prohibitions. 509 F.2d at 263 n.26. Here, by contrast, petitioners made false representations in the *contract itself*, and Conway was convicted of a criminal offense for conduct underlying the false representations.

c. This Court's review is also not warranted because even if the contract was not void ab inito, the Assistance Agreement was voidable at the government's election, and petitioners thus are not entitled to relief in any event. As petitioners acknowledge, as a result of petitioners' fraud, the government is entitled to renounce the contract and be returned to its pre-contract position, as long as the government does not continue to keep the benefits of the contract. Pet. 18. Here, contrary to petitioners' suggestion (Pet 29 n.10) the trial court properly denied petitioners' restitution claim for benefits allegedly conferred on the government, 60 Fed. Cl. at 96, and petitioners did not appeal that holding. Indeed, far from retaining any benefit of the bargain, the government never received *from petitioners* the $122 million in cash that the government provided to petitioners, or the value of the Centereach franchise. Accordingly, any distinction between a contract being void and being voidable is not critical to the outcome of this case.[2]

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[2] The government's election to regard the contract as void was timely. By the time the government discovered LISB's fraud, at the earliest in 1992 (Pet. App. 12a), "all of the government's obligations under the Assistance Agreement were completed." Pet. App. 35a. As the court of appeals correctly concluded, moreover, the government did not continue to accept performance under the Assistance Agreement after dis-

2. In all events, this Court's review of the court of appeals' holding that the contract was void ab initio is unwarranted because the court alternatively held that petitioners' prior material breach provided an independent basis for rejection of petitioners' damages claims. Pet. App. 2a, 31a, 36a, 37a. That fact-bound conclusion too does not warrant further review.

Petitioners contend (Pet. 24-27) that the court of appeals erred in stating that "any degree of fraud is material as a matter of law." Pet. App. 33a (quoting *Christopher Village, L.P.* v. *United States*, 360 F.3d 1319, 1335 (Fed. Cir. 2004), cert. denied, 543 U.S. 1146 (2005)). Petitioners further argue (Pet. 27-29) that the court's statement in that respect conflicts with decisions of other courts of appeals that hold that materiality turns on the extent to which a contract breach deprives the non-breaching party of the benefit of the bargain. The court of appeals' actual holding, however, is entirely faithful to that principle. The court of appeals' passing statement that "any degree of fraud is material" was unnecessary to the court's disposition of the issue, as the court's specifically held that petitioners' breach was material because the government did not receive the benefits of its bargain under the contract, *i.e.*, sound management of the bank. Pet. App. 33a.

Specifically, the court of appeals thus held that petitioners' misrepresentations were material "based on [the court's] discussion of causation in *supra* Part III.A.3." Pet. App. 33a. Part III.A.3 of the court of ap-

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covery of the fraud. *Id.* at 35a-36a. Finally, pursuant to the case management order governing this case, petitioners agreed that the government waived no counterclaim or defense by following the procedural order whereby the government was not obligated to file an answer to petitioners' 1993 complaint until 2001. *Id.* at 14a, 34a-36a.

peals' opinion in turn held that there was a direct and substantial causal link between petitioners' fraud and the government's decision to enter into the contract. *Id.* at 29a-31a. The court of appeals thus concluded that "the only reasonable inference is that had the plaintiffs stated the truth about Conway, they would not have received the contract. The plaintiffs have set forth no affirmative evidence such that a reasonable jury could conclude otherwise." *Id.* at 31a. Indeed, the government's supervisory agent responsible for negotiating and recommending the acquisition averred that, had LISB revealed the nature of the kickback scheme, the government would not have gone forward with the Agreement. *Id.* at 9a-10a. The trial court thus found that Conway's fraud was material and induced the agreement, explaining that the "Government contracted for full disclosure of any conflicts-of-interest in order to assure the safe and sound management of LISB, and it relied on Conway's statements. The Government thus justifiably relied on Conway's misrepresentation." *Id.* at 192a.[3]

Petitioners therefore err in arguing that the court of appeals held that a contracting party can be absolved of liability "if a contracting party made *any misstatement at all* that caused the other party to enter into the contract, even if the misstatement was not 'wil[l]ful or even negligent.'" Pet. 25 (emphasis added) (brackets in original). Nowhere did the court of appeals state that "any misstatement at all" that causes a party to enter into a contract can absolve a party of liability. The court of

[3] The trial court concluded that Conway's fraud could not be imputed to LISB, Pet. App. 194a-198a, but the court of appeals reversed that conclusion, *id.* at 26a-29a, and petitioners do not seek review of that issue in this Court.

appeals merely noted in a footnote, that the knowledge element required for rendering a contract void based on fraud is not a requirement under the prior material breach doctrine. Pet. App. 33a n.4 (quoting Restatement § 235 cmt. a). Petitioners' argument here, too, does not address the court of appeals stated bases for finding the false statements and omissions material: that the certification was an express condition precedent for the government's performance and that there would have been no contract but for the false certification.[4]

In short, petitioners deprived the government of the benefit of safe and sound management for which it had contracted as a fundamental purpose of the Assistance Agreement. LISB's fraud was neither minor nor insignificant, but rather tainted the very essence of LISB's performance. The acquisition approved by the government enabled LISB to obtain 36 branches and $122 million in cash, the benefits of which LISB would not have received but for the fraud, Pet. App. 29a-30a, while "LISB paid nothing for the franchise," and contributed only $100,000 to Centereach. *Id.* at 172a. LISB was required in turn to supply (1) honest and full disclosure, and (2) safe and sound management. LISB breached those obligations at the contract's inception, depriving the government of the expected benefit of its bargain.

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[4] For the same reasons, the court of appeals did not, as petitioners argue, establish a "*per se* test[] of materiality that completely disregard[s] the effect of the breach on the performance promised by the breaching party." Pet. 25-26. Again, the court of appeals specifically concluded that petitioners' certification was an express condition precedent for the government's performance and that, but for the misstatements and omissions, petitioners would not have received the contract. Pet. App. 29a-31a.

The court of appeals' fact-bound conclusion in this regard does not warrant plenary review by this Court.

3. Petitioners finally contend that the court of appeals' decision will discourage citizens from entering into commercial contracts with the government, Pet. 31-32, and "greatly unsettle the government contracting process." Pet. 15. That contention, too, is incorrect. For over half a century, the law has been settled—in a decision by the Federal Circuit's predecessor, the Court of Claims—that, if a plaintiff commits material fraud "in regard to the very contract upon which the suit is brought," all claims under the contract will be forfeited. *Little* v. *United States*, 152 F. Supp. 84, 87 (Ct. Cl. 1957). The contracting process has fared well because, contrary to petitioners' contention, it is not, in fact, unduly burdensome to require contractors to refrain from fraud in the inducement of government contracts.

Furthermore, as the Federal Circuit has correctly observed, *Winstar* claims frequently turn on their particular facts and circumstances, and each case must be considered on its individual merits. See, *e.g.*, *California Fed. Bank, FSB* v. *United States*, 245 F.3d 1342, 1347 (Fed. Cir. 2001), cert. denied, 534 U.S. 1113 (2002). In this case, petitioners were unable to make out their claim for breach of contract because of the material fraud they perpetrated in connection with the formation and performance of the contract, and because of their prior material breach of the contract.

The petitioners' hypothetical, where the government confiscates a $436 million airplane without paying for it (see Pet. 30-31), is not remotely analogous to the facts

here.[5] This is not a case in which a contractor supplied goods or services and the expected payments from the government were forfeited. As discussed above, petitioners have failed to return more than $100 million in government funds they procured by fraud, and they are hardly well-positioned to complain that the court of appeals' decision undermines public confidence in government contracts. Contrary to the petitioners' apparent belief (Pet. 34), the court of appeals' decision thus respects this Court's admonition that ordinary principles of contract construction and breach should be applied to government contracts. *United States* v. *Winstar Corp.*, 518 U.S. 839, 870-871, 895 (1996). Moreover, as the Court explained in *United States* v. *Mississippi Valley Generating Co.*, 364 U.S. 520, 565 (1961), non-enforcement of government contracts tainted by fraud is meant to "guarantee the integrity of the federal contracting process and to protect the public from the corruption which might lie undetectable beneath the surface of a contract conceived in a tainted transaction."

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[5] Moreover, as noted, the plaintiff's claimed damages, at a minimum, were significantly inflated. See *supra*, n.1.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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THE LONG ISLAND SAVINGS BANK, FSB and THE LONG ISLAND SAVINGS BANK OF CENTEREACH FSB,
Petitioners,

v.

UNITED STATES OF AMERICA,
Respondent.

On Petition for a Writ of Certiorari to The United States Court of Appeals for the Federal Circuit

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REPLY BRIEF FOR PETITIONERS

The government's brief in opposition tries to push the traditional no-cert. buttons. It does not defend the merits of the Federal Circuit's holding, presumably because the government recognizes that ruling to be indefensible. Instead, it seeks to obscure and recharacterize the holding below, in an evident effort to direct attention away from the baleful consequences of the court of appeals' aberrant and destructive rule.

That effort should not succeed. The Federal Circuit's holding is not only wrong, but clear and unequivocal in its import. As shown in the petition (at 16-24), the Federal Circuit ruled that a contract will be declared void *ab initio* whenever the government establishes "that the contractor (a) obtained the contract by (b) knowingly (c) making a false statement." App. 20a-21a. That voidness rule, which (as it did here) allows the government to keep all the contract benefits while itself breaching its contractual obligations and disclaiming liability for its breach, is flatly inconsistent with the universally recognized principles that should govern government contracts. The Federal Circuit then compounded its first error by holding that a breach of contract is *per se* material "as a matter of law" if it *either* caused the parties to enter into the contract or involved "any degree of fraud." *Id.* at 33a. This rule, too, radically departs from established contract principles, which deem a breach material only when it denies the affected party the essence of its bargain. See Pet. 24-29.

If our characterization of the Federal Circuit's rules is correct, and for the reasons below we think it

plainly is, review is imperative. These rules now govern all federal contracts of any size across the Nation. They have perverse and profoundly inequitable consequences – as is graphically illustrated by the facts of this case, where the government retained all of the contract benefits while breaching its obligations in a manner that cost petitioners hundreds of millions of dollars. And the issue presented here will arise repeatedly in the future; as a judge of the Court of Federal Claims recently described the decision below, it is "a model as to how the Federal Circuit analyzes an affirmative defense of fraud in the inception of the contract and its relationship to a prior material breach-of-contract defense." Mary Ellen Coster Williams, *2007 Government Contract Decisions of the Federal Circuit*, 57 AM. U. L. REV. 1075, 1128 (Apr. 2008). This case merits review.

A. The Void *Ab Initio* Holding Warrants Review.

The Federal Circuit held that, under federal common law, a government contract is void *ab initio* if a contractor "(a) obtained the contract by (b) knowingly (c) making a false statement." App. 20a-21a. The Brief in Opposition elides the essential problem with this holding: notwithstanding its *citation* of relevant Restatement provisions (see Opp. 9-10), the lower court's standard departs from the Restatement's rule and has never, to petitioners' knowledge, been embraced by any other court. The government makes no effort to explain how this holding can be squared with the general principles of contract law that should define federal law in this

area.[1] See, *e.g.*, *United States* v. *Winstar Corp.*, 518 U.S. 839, 895 & n.39 (1996).

The government instead (a) supplies a rationale for the outcome below that is quite different from the Federal Circuit's, contending that Conway's conduct amounted to fraud in the factum under the traditional test (Opp. 10-11); (b) denies the conflict in the courts of appeals that has been expressly acknowledged by the Federal and D.C. Circuits (Opp. 11-12); and (c) speculates that the distinction between fraudulent inducement and fraud in the factum would make no difference here (Opp. 12). Each contention is meritless.

a. The government's claim that Conway's conduct amounted to fraud in the factum is itself a radical departure from settled contract law. The government argues that the contract is void because LISB's alleged misrepresentations concerned its "essential terms." Opp. 10. But even assuming, improbably, that this is so, this argument misses the mark. The point is that the government neither does nor could assert that the purported misrepresentations in this case deprived it of the opportunity to understand (i) the *substance* of its contract with the Banks, or (ii) that it was actually entering into a contract. *Ibid.* And these are the *only* forms of misrepresentation that constitute fraud in the factum, and thereby render a contract void *ab initio*:

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[1] The accepted – and dramatically different – common-law test provides that a contract is void *ab initio* only if "because of a misrepresentation as to the character or essential terms of a proposed contract, a party does not know or have reasonable opportunity to know of its character or essential terms." Restatement (Second) of Contracts § 163 cmt. a (1981).

> Fraud in the execution [*i.e.*, factum] * * * entails deceiving a party to an agreement as to the very nature of the instrument it signs *so that the party actually does not know what he is signing, or does not intend to enter into a contract at all.*

Laborers' Pension Fund v. *A&C Envtl., Inc.*, 301 F.3d 768, 779 (7th Cir. 2002) (emphasis added, internal quotation marks omitted).[2] Accord, *e.g.*, *Langley* v. *F.D.I.C.*, 484 U.S. 86, 93 (1987) ("fraud in the factum * * * is the sort of fraud that procures a party's signature to an instrument without knowledge of its true nature or contents"). No court applying the traditional standard could have found that the conduct at issue amounted to fraud in the factum – as is well demonstrated by the government's failure to cite a single case finding a contract void *ab initio* in circumstances like these.[3]

b. Although not contesting that the Federal and D.C. Circuits dispute whether fraudulent misrep-

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[2] By contrast, "[f]raud in the inducement occurs when fraud induces a party to assent to a commitment that the party understands but to which the party would not otherwise have assented; the promisor knows what it is signing but its assent is induced by fraud." *A&C*, 301 F.3d at 779.

[3] Significantly, the government itself has heretofore consistently argued that Conway's conduct constituted fraudulent *inducement*. See Appellant's Br. at 2 (Statement of Issues: "Whether the trial court erred * * * in refusing to impute knowledge of fraud in the inducement of a Government contract * * *"); Appellant's Br. in Opp'n to Reh'g at 2 ("We explained that [LISB] had fraudulently induced the contract * * *"); Appellant's Br. in Opp'n to Renewed Reh'g Pet. at 7 ("The Panel properly held that a contract induced by fraud is void *ab initio*").

resentation should render a government contract void *ab initio* (see Pet. 19-22), the government claims that the D.C. Circuit's comprehensive critique of the Federal Circuit's view (see *United States ex rel. Siewick* v. *Jamieson Sci. & Eng'g, Inc.*, 214 F.3d 1372 (D.C. Cir. 2000)) was not part of the decision's holding. But it was.

The *Jamieson* court considered *both* (i) whether the contract at issue was void *ab initio* (*id.* at 1377), and (ii) whether it was voidable (*id.* at 1377-78). As to the first (the issue implicated here), the D.C. Circuit squarely held that the undisclosed conflicts of interest alleged by the *qui tam* relator did not render the contract void *ab initio*. It was in the course of this discussion that *Jamieson* described its disagreement with the Federal Circuit. *Id.* at 1377. The division between these circuits is therefore plain. *Jamieson*'s subsequent statement that it was unnecessary to reach an "ultimate answer" as to the quite different question of the contract's *voidability* (*id.* at 1378) should not obscure that fact.[4]

Moreover, a conflict in the circuits is not essential to justify review of this case. Because the Federal Circuit has exclusive appellate jurisdiction over almost all government contracting claims, that court's conclusion that "a [g]overnment contract tainted by fraud or wrongdoing is void *ab initio*"

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[4] The Fifth Circuit's decision in *Hayes International Corp.* v. *McLucas*, 509 F.2d 247, 263 n.26 (5th Cir. 1975), is equally in conflict. That court squarely rejected the appellant's argument that an illegal conflict of interest attributable to a government contractor rendered the underlying contract void *ab initio*. It is of no moment to the precedential force of the ruling that it came in a footnote, and did not further address whether the contract should be deemed voidable. See Opp. 11-12.

(App. 20a) (internal quotation marks omitted)), will have an immediate nationwide effect.

c. The government insists that "review also is not warranted because even if the contract was not void *ab initio*, the Assistance Agreement was voidable at the government's election" and petitioners would therefore be left empty-handed in either event. Opp. 12. This argument ignores both the trial court's rejection of the government's claim (App. 198a), and the government's express abandonment of this issue on appeal. See Appellant's Br. at 5 n.2. More fundamentally, the government's legal premise is wrong. Even *if* a rescissionary remedy is available to the government, petitioners would be entitled to substantial relief denied to them below: when a contract is disaffirmed, *both parties* are entitled to be restored to their pre-contract positions. See, *e.g.*, *Kamerman* v. *Curtis*, 33 N.E.2d 530, 532-33 (N.Y. 1941). Here, that restoration would have to take into account more than a decade of petitioners' ultimately successful efforts to turn around Centereach – fundamentally the same events at the heart of the trial court's $436 million damages calculation. See App. 120a-168a. Accordingly, even assuming *arguendo* that the value of cash and assets contributed by the government would be relevant to that equitable adjustment, the difference to petitioners between having *some remedy* and *no remedy* would be enormous.[5] Review is plainly warranted.

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[5] The government's argument that the trial court has already considered and rejected petitioners' right to restitutionary relief (Opp. 12) is a red herring. The trial court simply resolved that actual injury was a more appropriate measure of contract damages than restitution. See 60 Fed. Cl. 80, 96 (2004).

B. The Material Breach Holding Warrants Review.

The Federal Circuit's material breach holding likewise is a destructive one that rests on an aberrant interpretation of contract law. The court held that LISB's purported breach of contract, which it described as being Conway's submission of his false certification, was material because (a) the court perceived a "causal link" between the compliance representation and contract formation (App. 29a, 31a), and alternatively (b) because its "case law holds that any degree of fraud is material as a matter of law." App. 33a. The Federal Circuit thus reduced its materiality analysis to a determination whether fraud took place in formation of the contract and to a review of "causation" (*ibid.*), ultimately holding that the "breach" was material because "had the [petitioners] stated the truth about Conway, they would not have received the contract." App. 31a.

Contrary to the government's claim (Opp. 13), the Federal Circuit's focus on causation is completely at odds with general principles of contract law. See Restatement (Second) of Contracts §§ 241(a)-(e) (1981). The Restatement test, generally followed by the courts of appeals (see Pet. 27-28), requires a multi-factor analysis of the effect of a breach on the *performance* expected by the parties. See Pet. 26. In contrast, the Restatement nowhere suggests that the effect of a breach on the *formation* of a contract (whether or not the breach is related to fraud) is at all relevant to the materiality analysis.[6] The Federal Circuit's holding, which relied *expressly and*

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[6] Little wonder – it is nonsensical to say that a contract can be breached (let alone materially) before it comes into being.

exclusively on the conclusion that LISB's compliance representation affected formation of the contract, thus represents a substantial departure from settled contract principles.

The government defends this ruling principally by rewriting the Federal Circuit's holding. It dismisses the Federal Circuit's statement that "any degree of fraud is material" as dictum. Opp. 13 (internal quotation marks omitted). As to the rest of the court's analysis, the government suggests that the opinion is consistent with contract principles because the court "specifically held that petitioners' breach was material because the government did not receive the benefit of its bargain under the contract, *i.e.*, sound management of the bank." *Ibid.* This statement is bewildering; no hint of this purported holding appears in the Federal Circuit's opinion.

Nor could the Federal Circuit reasonably have adopted the holding attributed to it by the government. It would be astonishing if, following open bidding and lengthy negotiation, the government had agreed to cede $122 million and highly favorable accounting treatment (essentially a cash substitute) in exchange for just "(1) honest and full disclosure, and (2) safe and sound management." Opp. 15.[7] In truth, there was far more to the deal. As with all of the *Winstar* agreements, the government sought to "avoid the insurance liability [of the failing S&Ls, totaling some $85 billion] by encouraging healthy thrifts and outside investors to take over ailing institutions." *Winstar*, 518 U.S. at 847. By agreeing to take over Centereach, LISB assumed a $625 million portion of that potential

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[7] Neither term appears in the contract documents.

liability. See App. 113a. Moreover, it remains undisputed that the responsible government regulators viewed petitioners' management as "sterling" (App. 123a), that they *never* concluded that the Banks had been operated in other than a safe and sound manner, and that the Centereach rescue was a success. See Pet. 7-10. Accordingly, unless one accepts the government's *ipse dixit* that the "very essence" of its purpose in executing the agreement was to obtain morally blameless management for Centereach (Opp. 15), there can be no doubt that the government obtained substantially what it desired – LISB's assistance in solving the Centereach piece of the savings and loan crisis.

It bears emphasis that the government's bizarre recharacterization of the contract should not deflect the Court's focus from the erroneous and harmful legal rules announced by the Federal Circuit; we describe the contract simply to confirm that the government cannot be accurately depicting the legal holding below. The fundamental point is that the Federal Circuit *did not* consider the materiality question under anything like the Restatement test. It instead concluded that the asserted importance of LISB's compliance certification to the *formation* of the contract made the resulting "breach" material. This creates a profound conflict with contract law principles recognized everywhere else.

C. The Federal Circuit's Decision Will Have Grave And Inequitable Consequences For Government Contractors.

The government has remarkably little of substance to say about the sweeping implications of the Federal Circuit's decision. The government declares repeatedly that this case involves the sort of

contract addressed in *Winstar* (Opp. 2, 16-17), but that observation is wholly beside the point. Whatever the volume of continuing *Winstar* litigation, the decision below involves *general* contract rules that will apply to *every* substantial claim for contract damages against the United States. See Pet. 30. Nor does the government contest that countless government contracts require broad compliance representations much like the one at issue in this case, or offer a single word about the inherent difficulty of ensuring that every statement in such a certification is correct. See Pet. 31-32. The government thus seems to recognize that, under the Federal Circuit's rules, a single false statement in such standard certifications can cause the contracts in which they appear to be declared void or materially breached at their inception, with profoundly unfair remedial consequences. And the government evidently concedes that quasi-contract remedies such as *quantum meruit* will not be available to soften the blow of these harsh forfeiture rules. See Pet. 33-34.

Where the government does object, its protestations do not persuade. It is not true, for example, that government contractors have labored under these harsh contract rules, or their equivalent, for over 50 years. See Opp. 16 (citing *Little* v. *United States*, 152 F. Supp. 84, 87 (Ct. Cl. 1957)). The panel's initial decision in this case (App. 38a-68a) extended *Little*'s holding *for the first time* to alleged misrepresentations occurring during contract formation. See Jerry Stouck & Robert A. Caplen, *The Forfeiture Of Claims Act Today*, 07-9 BRIEFING PAPERS 1, 4 (Aug. 2007). Moreover, that profoundly erroneous initial decision was vacated at the direction of the full court. See App. 2a.

And while the government asserts that petitioners' warplane hypothetical "is not remotely analogous" to this case, (Opp. 16) – presumably in the sense that banks and warplanes are quite different – it does not deny that total forfeiture would follow under the decision below if a defense contractor were to build a $436 million warplane that perfectly met the government's specifications, but the contractor's compliance representation in procuring the contract were later found wanting.[8] See Pet. 31. In addition to being clearly at odds with general contract principles, this result cannot be squared with the approach selected by the political branches to address contract infirmities of this kind, and accordingly is of great concern to the government contracting community. See Br. for *Amicus Curiae* National Defense Industrial Ass'n, at 13-18.

In short, nothing the government has said blunts the force of petitioners' argument for review. Wholly apart from the $436 million at stake in this one case, the decision below settled national rules of considerable importance. Those rules threaten to disrupt the government contracting process by jettisoning established contract principles in favor of

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[8] The analogy is apt. LISB provided valuable services to the government in assuming responsibility for Centereach and its liabilities, and was stripped by the government's breach of a substantial portion of its compensation – the right to record supervisory goodwill in place of cash on its books. And the government's cavalier pronouncement that the punitive result below is warranted because the contract and associated government funds were "procured by fraud" (Opp. 17) only underscores our point. Under general contract principles, that accusation should mark the beginning of the analysis, not the end.

a novel and poorly considered approach. This Court's intervention is clearly warranted.

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted.

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Supreme Court of the United States

THE LONG ISLAND SAVINGS BANK, FSB
and THE LONG ISLAND SAVINGS BANK
OF CENTEREACH FSB,

Petitioners,

v.

UNITED STATES OF AMERICA,

Respondent.

On Petition For A Writ Of Certiorari To The United States Court Of Appeals For The Federal Circuit

BRIEF OF THE NATIONAL DEFENSE INDUSTRIAL ASSOCIATION AS *AMICUS CURIAE* IN SUPPORT OF THE PETITION FOR A WRIT OF CERTIORARI

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STATEMENT OF INTEREST

With the written consent of the parties, as reflected in the letters on file with the Clerk, *Amicus Curiae* National Defense Industrial Association ("NDIA") submits this brief in support of Petitioner, pursuant to Rule 37.2(a) of this Court.[1]

Contractors provide the federal government with supplies, construction, and services under contracts with an obligated value in fiscal year 2005 of approximately $381 billion, or some 35% of the discretionary budget of the entire United States government. *See* U.S. CENSUS BUREAU, CONSOLIDATED FEDERAL FUNDS REPORT FOR FISCAL YEAR 2005 xx, http://www.census.gov/prod/2007pubs/cffr-05.pdf.

NDIA is a non-profit organization comprised of more than 1,300 corporations and 47,000 individuals spanning the entire spectrum of the defense industry. Members include individuals from academia, government, the military services, small businesses, corporations, prime contractors, and the international community. They fulfill a large share of the Department of Defense's contracts for goods and services.

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[1] The parties were notified ten days prior to the due date of this brief of the intention to file. The parties have consented to the filing of this brief.

No counsel for either party to this proceeding authored this brief in whole or in part, and no person or entity other than the National Defense Industrial Association ("NDIA") or its members contributed money to the preparation or submission of the brief. *See* Sup. Ct. R. 37.6.

Members are located in and perform services and contracts throughout the United States.

NDIA's members have come to rely on the predictable system of government contracting established by the Federal Acquisition Regulation ("FAR")[2] and related procurement and regulatory requirements. A major element of NDIA's mission is to promote a "vigorous, responsive, government – Industry National Security **Team**." National Defense Industrial Association, *Who we are – what we offer!*, http:// www.ndia.org/Content/NavigationMenu/Resources1/Mission_Statement.htm (emphasis added) (last visited Apr. 30, 2008). NDIA believes that the Federal Circuit's decisions in *Long Island Savings Bank, FSB v. United States*, 476 F.3d 917 (Fed. Cir. 2007) (vacated) and *Long Island Savings Bank, FSB v. United States*, 503 F.3d 1234 (Fed. Cir. 2007) serve to undermine the stability of the federal contracting process by establishing a new rule governing treatment of tainted contracts that is inconsistent with the long-standing regime established pursuant to direction from Congress and the President and explicitly designed to protect the integrity of the public procurement system from the corruption associated with tainted contracts. The new rule gives rise to uncertainty and unduly increases the risk of doing business with the federal government. NDIA and its membership have a significant

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[2] The Federal Acquisition Regulation ("FAR") is located at Title 48 of the Code of Federal Regulations.

interest in this matter and wish, *first*, to call the attention of the Court to the unintended consequences of the rule and, *second*, to point out that the rule is simply unnecessary in light of the existing statutory and regulatory regimes.

SUMMARY OF ARGUMENT

Long Island Savings Bank, FSB v. United States, 503 F.3d 1234 (Fed. Cir. 2007) ("*LISB*"), had its inception as a thrift case under *United States v. Winstar Corp.*, 518 U.S. 839 (1996), but its holding extends far beyond the *Winstar*-line of cases, creating a rule which inadvertently and unnecessarily injects a heavy dose of uncertainty into the federal procurement process with serious consequences for the entire government contracting community. In *LISB*, the Federal Circuit extended its rulings in *Godley v. United States*, 5 F.3d 1473 (Fed. Cir. 1993) and *J.E.T.S., Inc. v. United States*, 838 F.2d 1196 (Fed. Cir. 1988) (two procurement fraud cases holding that government contracts tainted by fraud at their inception are void *ab initio*), bolstering its conclusions with a misapplication of the Supreme Court's decision in *United States v. Mississippi Valley Generating Co.*, 364 U.S. 520, 563 (1961) (a procurement case holding that a contract tainted by fraud may be voided at the government's discretion, not that the contract was void *ab initio*) and general principles of federal and state contract and agency law. The Federal Circuit concluded that: (1) where a contract with the federal

government is tainted from its inception by a false certification executed by a rogue employee, it is void *ab initio*, even though the contract was completely performed to the full satisfaction of the agency; and (2) a false certification made when a company enters into a contract with the government constitutes a prior material breach, preventing the contractor from seeking any claims for damages and excusing the government from any subsequent obligation on the contract, despite the fact that the contract was fully and completely performed and that the breach was wholly immaterial to the contract performance as a whole. *See LISB*, 503 F.3d at 1251-53.

As to the first issue of voidness, the decision extends and stretches Supreme Court jurisprudence as to treatment of contracts tainted by fraud at their inception, which has held only that protection of the public fisc and the people's faith in government is "fully accorded" when the government has discretion to determine whether to disaffirm such contracts, making such contract voidable. *See United States v. Miss. Valley Generating Co.*, 364 U.S. 520, 563 (1961) ("This protection can be fully accorded only if contracts which are tainted by a conflict of interest on the part of a government agent may be disaffirmed by the Government."). Never has the Supreme Court held that a tainted contract is automatically void *ab initio*. *See United States ex rel. Siewick v. Jamieson Sci. & Eng'g*, 214 F.3d 1372, 1377 (D.C. Cir. 2000) ("There is no suggestion in the [*Mississippi Valley*]

opinion that the contract self-destructed into voidness . . . ").

As to the second issue of prior material breach, the decision creates a situation where **any** misrepresentation, miscertification, or misstatement (whether knowingly made or merely accidental) could be considered a "material breach," even where there is no substantive impact on the performance of the contract. Under the court's rule, any such prior breach would prevent the contractor from recovering any damages arising from a subsequent government breach of its contractual obligations; simultaneously, the government itself would be excused of all obligations under the contract, thereby entitling it to retain all of the benefits of the contractor's work and forcing the contractor to carry the entire burden of the failed contract without any compensation. And all of this occurs because – in *post hoc* litigation – government attorneys removed from actual contract performance allege a broadly applicable affirmative defense to help them win their case. Such an unbalanced result is, on its face, bad policy for both the government and its many contractors, and arises from a rule that is quite unnecessary to deter procurement fraud in light of existing statutory and regulatory requirements described below.

The Federal Circuit's decision in *LISB* is, in application, inconsistent with the voidability regime prescribed by 18 U.S.C. § 218, Executive Order

12,448 and FAR Subpart 3.7[3] as federal policy *vis-à-vis* contracts tainted at their inception by the serious crimes of conflict of interest and bribery, which explicitly contemplates that such contracts are voidable at the election of the government, not simply – and automatically – void *ab initio*. The holding in *LISB* will have the practical effect of limiting the discretion afforded federal agencies by Congress and the President as to treatment of tainted contracts. And it exposes contractors whose contracts are "tainted" by false certifications involving matters often considered less serious than conflict of interest or bribery to consequences clearly not anticipated by Congress and the President when prescribing the voidability regime.

The government already has a host of remedial measures available to protect the integrity of the procurement process and exact justice from corrupt contractors and their employees. Creating a general rule that allows the government to avoid summarily its contractual obligations (whether by automatically voiding a contract or by achieving much the same result by virtually nullifying the contract through invocation of the "prior material breach" doctrine) is,

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[3] The titles of these authorities are, respectively, 18 U.S.C. § 218 (Voiding transactions in violation of chapter; recovery by the United States); Exec. Order No. 12,448, 48 Fed. Reg. 51,281 (Nov. 4, 1983) (Exercise of Authority Under Section 218 of Title 18, United States Code); and FAR Subpart 3.7 (Voiding and rescinding contracts).

for reasons discussed above, bad for the defense industry and bad for the government which provides for our national defense. NDIA has a vested interest in ensuring that both of these interests are recognized, and, for the following reasons urges this Court to reverse the decision in *LISB*.

First, the rule announced in *LISB* is automatic in operation in that it contemplates that a tainted contract will "self-destruct[ ] into voidness," *Jamieson Science & Engineering*, 214 F.3d at 1377, thereby reflexively punishing contractors without regard to the specific facts and circumstances of the offense. Such an outcome is unfair on its face.

Second, imposing such an automatic rule is inconsistent with the concepts of fundamental fairness embodied in the statutory and regulatory scheme, which was enacted in the wake of the hugely controversial Dixon-Yates matter and the Supreme Court's decision in *Mississippi Valley*, 364 U.S. 520 (1961). This statutory and regulatory scheme explicitly grants discretion to agencies *vis-à-vis* contracts tainted by bribery or conflict of interest, later expanded to address procurement integrity violations by explicitly providing the contracting agency an election between disaffirmance and treating the contract as fully in effect and affording "[t]he person or entity affected . . . an opportunity to submit pertinent information on its behalf before a final decision is made" and assuring that any "remedy shall take

into consideration the fair value of any tangible benefits received and retained by the agency."[4] Based on information obtained in this process, the agency can take the action appropriate to its own interests, *i.e.*, it can elect either to void and rescind the contract or to treat it as fully in effect. The Federal Circuit's ruling is inconsistent with this agency election with respect to tainted contracts and, as well, with the discretion granted agencies by the Executive Order to impose other remedies and to consider the fair value of benefits received.

Third, the Federal Circuit's ruling will have the unintended **practical** effect of vitiating an agency election to treat a contract as fully in effect, if a contractor later pursues its rights to appeal a contracting officer decision to a Board of Contract Appeals or the Court of Federal Claims pursuant to the Contract Disputes Act, 41 U.S.C. § 601, *et seq*. That is because the Boards and Court of Federal Claims will be required by *LISB* to declare any contract tainted by a false certification void *ab initio*, even if the agency had determined to proceed. Ironically, the practical effect of such a policy will be to encourage contractors to abandon performance. Otherwise, they will face a later determination that the contract was void *ab initio*. Neither Congress nor the Executive Branch are likely to have contemplated such a

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[4] Exec. Order No. 12,448, 48 Fed. Reg. 51,281 (Nov. 4, 1983).

conflicted real-world process and potential outcomes when they crafted the voidability regime delineated in FAR Subpart 3.7.

ARGUMENT

I. THE FEDERAL CIRCUIT'S DOCTRINE THAT A TAINTED GOVERNMENT CONTRACT IS AUTOMATICALLY VOID *AB INITIO* IS NOT BASED ON SUPREME COURT JURISPRUDENCE, IS INCONSISTENT WITH THE DISCRETION EXPLICITLY GRANTED AGENCIES AS TO SUCH CONTRACTS BY STATUTE, EXECUTIVE ORDER, AND REGULATION, AND WILL HAVE UNINTENDED PRACTICAL CONSEQUENCES FOR THE FEDERAL PROCUREMENT PROCESS.

A. This Court Should Grant Certiorari To Review the New "General Rule" That a Tainted Contract Is Automatically Void *Ab Initio*.

The Federal Circuit's ruling in *LISB* is unequivocal that "the general rule is that a Government contract tainted by fraud or wrongdoing is void *ab initio*." *LISB*, 503 F.3d at 1245 (internal quotation marks omitted). The decision does not identify any exceptions to this "general rule" and, indeed, there can be none. *Id.* at 1251 ("[T]he government has proven that the plaintiffs obtained the contract by knowingly making a false certification. The

Assistance Agreement was thus tainted at its inception by fraud and void ab initio."). At no time has this Court held that public policy requires a contract tainted at its inception by fraud to be found void *ab initio*. In *Mississippi Valley*, the Supreme Court did use strong language in holding the contracts in question voidable:

> Although nonenforcement frequently has the effect of punishing one who has broken the law, its primary purpose is to guarantee the integrity of the federal contracting process and to protect the public from the corruption which might lie undetectable beneath the surface of a contract conceived in a tainted transaction.

Miss. Valley Generating Co., 364 U.S. at 564-65. And strong language was appropriate because *Mississippi Valley* addressed contracts arising out of the Dixon-Yates scandal, involving allegations of use of public sector funds for private sector purposes and conflict of interest.[5]

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[5] The controversy started in the early days of 1953 when "President Eisenhower announced his intention . . . to encourage . . . private enterprise or local communities to provide power-generating sources in partnership with the Federal Government," *Miss. Valley Generating Co.*, 364 U.S. at 526, and takes its hyphenated name from Edgar H. Dixon, President of Middle South Utilities and Eugene A. Yates, Chairman of the Board of the Southern Company, whose companies jointly submitted proposals in late 1953 and the spring of 1954 to the Atomic Energy Commission to provide power to the Tennessee

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But even given the unusual circumstances of the Dixon-Yates controversy, this Court refrained from holding that a "tainted" contract is automatically void, holding rather that it is **voidable** at the agency's discretion. *Jamieson Sci. & Eng'g*, 214 F.2d at 1377 ("There is no suggestion in [*Mississippi Valley*] that the contract self-destructed into voidness . . ."). And the Federal Circuit was careful not to assert that the Supreme Court so held. Thus, while the Federal Circuit has characterized *Mississippi Valley* as a case in which the Supreme Court found a contract voidable "because similarly tainted by a prohibited conflict of interest" *LISB*, 503 F.3d at 1246 (quoting *J.E.T.S.*, 838 F.2d at 1200), the court explicitly identifies itself as the originator of this "general rule" which was "established . . . in *J.E.T.S.*, which held that a government contractor's false certification barred its subsequent claim." *Id.* at 1246. The Federal Circuit's ruling is the culmination of the gradual decisional evolution of the procurement doctrine that

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Valley Authority. The proposal (and the Eisenhower Administration) became embroiled in the then ongoing controversy over private versus public power and the matter went downhill from there, encountering on the way down the Supreme Court decisions in *Mississippi Valley* and extensive congressional hearings leading to passage of the statute establishing the voidability regime that includes 18 U.S.C. § 218. *Miss. Valley Generating Co.*, 364 U.S. 520, 526-27; Pub. L. No. 87-849, 76 Stat. 1125 (codified as amended at 18 U.S.C. § 218); S. Rep. No. 87-2213 (1962), *as reprinted in* 1962 U.S.C.C.A.N. 3852, 3863; *see also generally* AARON WILDAVSKY, DIXON-YATES: A STUDY IN POWER POLITICS (Yale Univ. Press 1962).

a tainted contract is **by definition** unenforceable – even if the taint arose from the covert actions of a lone employee that, when revealed, were rejected and, to the extent practicable, disclosed and corrected by the contractor. *See LISB*, 503 F.3d at 1245-46 (citing *Godley*, 5 F.3d at 1476; *J.E.T.S.*, 838 F.2d at 1200).

The effect of this doctrine is that, without regard to the specific facts and circumstances, a contract which is tainted (through a false certification) has "self-destructed into voidness," *Jamieson Science & Engineering*, 214 F.3d at 1377, so that if it ever existed at all, it is now extinct and beyond the power of anyone to revive it. The doctrine precludes even the federal agency that awarded the contract and whose operations may be dependent on its continuance from saving the contract. It precludes action by the federal agency that, as the D.C. Circuit observed, "might be concerned that [the contract's] disaffirmance would unduly impede future transactions with the contracting firm (possibly in possession of skills or other resources of exceptional value to the government) or with other potential contractors." *Id.* at 1377.

Read literally, the Federal Circuit's rule would eliminate any discretion of the contracting agency as to treatment of contractors involved in a contract tainted by a false certification or any other fraudulent act. Such an outcome is, again, inconsistent with and in fact contrary to the voidability regime established

by Congress through statute and the President through Executive Order.

B. The Federal Circuit's Ruling Is Inconsistent With Federal Procurement Policy Regarding Contracts Tainted by the Serious Crimes of Bribery and Conflict of Interest That Gives Agencies an Election To Disaffirm Such Contracts or Treat Them as Fully in Effect.

Both the Federal Circuit's decision in this case and its doctrine that a tainted contract is void *ab initio* are apparently expressive of a well-intentioned belief that equating "taint" with "voidness" is a proposition that "protects the integrity of the federal contracting process and safeguards the public from undetectable threats to the public fisc." *LISB*, 503 F.3d at 1254 (quoting *Godley*, 5 F.3d at 1475). But the legislative and executive branches have already addressed these concerns through a highly articulated, comprehensive, and integrated plan addressing bribery and conflict of interest schemes – perhaps the most pernicious and prototypical types of procurement "fraud" – and they have done so precisely in response to the Dixon-Yates matter whose facts informed this Court's decision in *Mississippi Valley*. *See generally*, *e.g.*, Pub. L. No. 87-849, 76 Stat. 1119-26 (codified as amended at 18 U.S.C. §§ 201-18).

On October 23, 1962, Congress passed Public Law 87-849 which explicitly granted authority to government agencies to exercise discretion in determining

whether to void transactions that violated a range of statutory provisions prohibiting, among other things, conflicts of interest and bribery:

> **In addition to any other remedies provided by law the President or, under regulations prescribed by him, the head of any department or agency involved, may declare void and rescind any contract**, loan, grant, subsidy . . . or the performance of any service or transfer or delivery of any thing to, by or for any agency of the United States . . . , in relation to which there has been a final conviction for any violation of this chapter [18 U.S.C. § 201 *et seq.*], and the United States shall be entitled to recover in addition to any penalty prescribed by law or in a contract the amount expended . . . or the reasonable value thereof.

Pub. L. No. 87-849, § 218, 76 Stat. 1125 (codified at 18 U.S.C. § 218) (emphasis added).

Congress's use of the word "may" in Section 218 is to be read in this instance as providing "the head of any department or agency involved" a choice as to whether to "void and rescind" a contract that has been tainted by violation of the provisions cited. Congress specifically stated its intent to grant federal agencies discretion as to whether they wished to void and rescind contracts tainted by the crimes of bribery and conflict of interest. In this regard, the opening language of Section 218 makes clear that Congress did not intend the section to "operate to modify the Supreme Court decision relating to the Dixon-Yates

matter." S. REP. NO. 87-2213 (1962), *as reprinted in* 1962 U.S.C.C.A.N. 3852, 3863. And in fact Section 218 is wholly consistent with the Supreme Court's decision in *Mississippi Valley* in that, like that decision, it gives "the government the right to 'disaffirm a contract which is infected by an illegal conflict of interest'" without "depriving the government of its election . . . to treat the contract as fully in effect." *Jamieson Sci. & Eng'g*, 214 F.3d at 1377 (quoting *Miss. Valley Generating Co.*, 364 U.S. at 566).

On November 4, 1983, President Reagan issued Executive Order 12,448, which implemented 18 U.S.C. § 218 and "provide[d] federal agencies with the authority to promulgate regulations for voiding or rescinding contracts or other benefits obtained through bribery, graft or conflict of interest." Exec. Order No. 12,448, 48 Fed. Reg. 51,281 (Nov. 4, 1983). Notably, the Executive Order explicitly provides for procedural protections for the contractor whose employee has, for example, bribed a public official in an effort to obtain a contract:

> Implementing regulations adopted pursuant to this Order shall, at a minimum, provide the following procedural protections:
>
> (a) Written notice of the proposed action shall be given in each case to the person or entity affected;
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> (b) The person or entity affected shall be afforded an opportunity to submit pertinent information on its behalf before a final decision is made;

> (c) Upon the request of the person or entity affected, a hearing shall be held at which it shall have the opportunity to call witnesses on its behalf and confront any witness the agency may present; and
>
> (d) The head of the agency or his designees shall issue a final written decision specifying the amount of restitution or any other remedy authorized by section 218, provided that such remedy shall take into consideration the fair value of any tangible benefits received and retained by the agency.

Id. § 3.

The terms of 18 U.S.C. § 218 and Executive Order 12,448 establish that, from the outset, the legislative and executive branches intended that a contract award tainted by the serious crimes of bribery and conflict of interest should be carefully considered and – potentially, but **not automatically** – voidable at the discretion of the agency, thus forcing the contractor to forfeit all proceeds from the contract if deemed void. But the approach of the legislative and executive branches to protect the federal contracting process and safeguard the public "from undetectable threats to the public fisc," *Godley*, 5 F.3d at 1475, is fundamentally different from the Federal Circuit's approach.

Contrary to the doctrine set forth in *LISB*, the statute and Executive Order: (1) provide the agency discretion to protect its interests *vis-à-vis* its contractors by making the contract **voidable**, rather than

void *ab initio*; and (2) provide contractors the protections of process, including notice, the opportunity to respond, hearing and consideration of the value the government received from contract performance. *Accord* FAR 3.704 (identifying the general policy that "the agency head . . . shall consider the facts available and, if appropriate, **may** declare void and rescind contracts, and recover the amounts expended.") (emphasis added); FAR 3.705 (describing the procedures that an agency should use in voiding or rescinding contracts, indicating that the procedures "shall be as informal as practicable, consistent with the principles of fundamental fairness," and also that the final decision "shall be based on the information available to the agency head . . . including any pertinent information submitted . . . If the agency declares void and rescinds the contract, the final decision shall . . . reflect consideration of the fair value of any tangible benefits received and retained by the agency.").

C. The *LISB* Ruling Ironically Allows Contractors Whose Tainted Contracts Are Fully in Effect To Exercise Their Due Process Right of Appeal Under the Contract Disputes Act, but at Such a Risk That a Rational Contractor Would Abandon Performance, Thereby Frustrating the Intent of the Policy.

The Federal Circuit has held that "taint" is equivalent to "void." In application, this holding affects agency capacity to exercise discretion and

election as to contracts tainted by bribery, conflict of interest, or violation of procurement integrity rules that neither the Congress nor the Executive Branch could have contemplated when they crafted the process now set out in detail in FAR Subpart 3.7.

A contractor whose bribery-tainted contract the agency has "elected to treat as fully in effect" and who subsequently has a significant claim would have the right to appeal a Contracting Officer's final decision denying the claim to the cognizant Board of Contract Appeals or the Court of Federal Claims. *See* 41 U.S.C. §§ 606, 607. The contractor will recognize that, as both of these fora are bound by decisions of the Federal Circuit, its appeal will be subject to the affirmative defense that the contract was tainted and void *ab initio* and, like *LISB*, it will likely lose not only its appeal of the denied claim but the entire contract and all its proceeds. 28 U.S.C. §§ 1295(a)(10), (b), 1346(a)(2), 1491(a)(1). In these circumstances, a rational contractor would not appeal but, instead, choose to abandon performance of the contract, thereby frustrating the agency's purpose when it exercises its election to keep the contract "fully in effect," not to mention frustrating the purpose of the voidability regime.

II. THE FEDERAL CIRCUIT'S ALTERNATE HOLDING REGARDING THE DOCTRINE OF PRIOR MATERIAL BREACH FURTHER MAGNIFIES THE BUSINESS RISKS TO DEFENSE CONTRACTORS BECAUSE ANY MISREPRESENTATION CAN ESSENTIALLY DISSOLVE THE CONTRACT, REGARDLESS OF WHETHER IT IS MATERIAL TO THE CONTRACT AS A WHOLE.

The *LISB* ruling that a "prior material breach" arising from a contractor misrepresentation excuses government performance elides the question of the materiality of a misrepresentation to the substance of the contract. In order for a contract breach to be material, the breach must impede the breaching party's performance. *See* RESTATEMENT (SECOND) OF CONTRACTS § 241; *see also Hansen Bancorp, Inc. v. United States*, 367 F.3d 1297, 1312 (Fed. Cir. 2004) (observing that, in order for a breach to be material, it "must be of a relatively high degree of importance" to the contract overall) (internal quotation marks omitted). Where the performance originally agreed to between the parties is unaffected by the breach, contract performance is not excused. *See* RESTATEMENT (SECOND) OF CONTRACTS § 241 cmt. a (observing that an immaterial breach instead gives rise to a claim for damages for partial breach).

We do not restate Petitioners' argument here, but we note that under the prior material breach standard announced by the Federal Circuit, *see LISB*, 503 F.3d at 1245-46, 1251-52, **any** misrepresentation

(whether express or implied), **any** incorrect certification (whether with regard to a specific provision of law or compliance with the law generally), or **any** misstatement of fact (even if simply an innocent mistake) could constitute a material breach even if there is no substantive impact on the performance of the contract. In submitting a proposal to the government, if a contractor certifies its compliance with applicable law, and that certification later turns out to have been incorrect, the government may yet declare that it never had any obligation under the contract, and the government may yet avoid its contractual obligations with impunity, while still retaining the benefit it received from the contractor's performance – even if that benefit far exceeds any conceivable damage suffered by the government.

In reality, the facts and circumstances surrounding the false certification in the *LISB* decision are easily replicated in any traditional government contract. In submitting a proposal for a government contract, FAR 4.12 requires all entities to submit and maintain certain representations and certifications with respect to their compliance with various regulatory requirements. *See, e.g.*, FAR 52.203-2 (Certificate of Independent Price Determination); FAR 52.203-11 (Certification and Disclosure Regarding Payments to Influence Certain Federal Transactions); FAR 52.209-5 (Certification Regarding Debarment, Suspension, Proposed Debarment, and Other Responsibility Matters); FAR 52.214-14 (Place of Performance – Sealed Bidding); FAR 52.219-1 (Small Business

Program Representations); FAR 52.219-22 (Small Disadvantaged Business Status); FAR 52.222-18 (Certification Regarding Knowledge of Child Labor for Listed End Products); FAR 52.222-25 (Affirmative Action Compliance); FAR 52.222-38 (Compliance with Veterans' Employment Reporting Requirements); FAR 52.225-2 (Buy American Act Certificate).

All standard federal solicitations include a Section K, "Representations and Certifications," wherein offerors make scores of representations and assurances that they currently conform with a wide variety of broadly applicable laws. The government relies upon these representations in making the contract award. Any number of these representations and certifications could be suitable surrogates for the certification executed by Mr. Conway in *LISB*, in that each and every certification provides an opportunity for an individual employee or agent with responsibility for the relevant subject matter to make a false certification without the knowledge of the contractor or principal.

Eliminating consideration of the materiality of a misrepresentation to the contract as a whole will necessarily give rise to *post-hoc* litigation scenarios where the interests of the agency in maintaining a contract do not align with the interests of the Department of Justice in winning a case. In such instances, the agency's interests will become irrelevant and the contract subject to avoidance the moment the Department of Justice identifies a purported fraud,

an alleged misrepresentation, or even a simple mistake to the Court. Consider the following examples:

- The U.S. Army awards a $100 million construction contract to build a number of buildings on an Army base. The winning small business contractor submits a proposal certifying, among other things, that it complies with the Drug Free Workplace Act. *See* FAR 23.504 and FAR 52.223-6. Unbeknownst to the contractor, one of its senior managers is selling prohibited substances in the workplace. After the construction project is completed – once the Army has full use of the depots, barracks, recreational facilities, and mess halls – the senior manager is convicted for drug-related crimes. As required under the contract, *see* FAR 52.223-6(b)(5), the contractor notifies the Army of the conviction, and the Army takes no action. However, later, when the contractor pursues a claim against the Army for increased construction costs, the government claims that the contractor is not entitled to increased costs, and furthermore, the Army is excused from any performance under the contract based on the false certification that the contractor complied with the Drug Free Workplace Act, 41 U.S.C. § 701.[5] Under the Federal Circuit's rule, the Army would be entitled to keep all of the buildings

[5] In fact, such a result would appear to be mandated under the Federal Circuit rule, despite the fact that FAR 52.223-6(d) specifically recognizes that the agency has discretion in imposing an appropriate remedy, including suspending contract payments, entering default termination against the contractor, suspending the contractor, or initiating debarment proceedings.

constructed by the contractor for free – absolved of any responsibility to pay a single cent on the contract – and the contractor would be forced to bear the entire burden of the contract costs, all because of the errant acts of a rogue employee.

- A large aerospace company enters into a $500 million contract with the U.S. Air Force to provide upgrades to military aircraft. As required under FAR 9.505, the contractor certifies that it does not have an organizational conflict of interest ("OCI"); however, unbeknownst to the contractor, one of the employees working on the program previously helped define the system requirements while working for another company. Many years later, after the system upgrade is complete, the contractor discovers the employee's OCI and discloses this fact to the government. Under the Federal Circuit's rule, the Air Force would be allowed to retain the entire benefit of the systems upgrade, while also requiring return of the total $500 million contract price; meanwhile, the bewildered aerospace company would be left with nothing except nearly $500 million in liabilities relating to the contract performance that was acceptable to the Air Force.[7]

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[7] This hypothetical regarding potential OCIs is not that difficult to imagine. Given the increasing consolidation in the defense industry and given the increased frequency in which OCI issues have arisen in recent years, *see, e.g., Axiom Res. Mgmt., Inc. v. United States*, 78 Fed. Cl. 576 (2007); *Greenleaf Constr. Co.*, B-293105, 2006 CPD ¶ 19 (Jan. 17, 2006); *Alion Sci. & Tech. Corp.*, B-297022, 2006 CPD ¶ 2 (Jan. 9, 2006), it is easily conceivable that an unidentified OCI might excuse further

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Without a requirement that a prior breach be material to the contract as a whole, government suppliers face significant risk and uncertainty in doing business with the government – not merely the risk that the contractor may be held liable for the damages the government may suffer (a risk that a contractor should rightly bear), but also the risk that it may receive absolutely no compensation from the government under a contract that it fully and adequately performs, while the government retains the full benefit of such effort (a risk that a contractor should **not** be forced to bear).

CONCLUSION

The Federal Circuit's void *ab initio* rule will give rise to unfair consequences and disrupt the statutory and regulatory scheme established by Congress and the President. Furthermore, the Federal Circuit's alternate holding with regard to a contractor's prior material breach presents a patently inequitable situation where a government contractor is forced to

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performance by the Government on a contract under the Federal Circuit's rule. *Accord United States v. Sci. Applications Int'l Corp.*, 502 F. Supp. 2d 75 (D.D.C. 2007) (holding that a contractor could be liable under the civil False Claims Act for a false certification relating to an OCI); *United States ex rel. Harrison v. Westinghouse Savannah River Co.*, 352 F.3d 908 (4th Cir. 2003) (same).

bear enormous risks for simple mistakes, while the Government is able to avoid any responsibility.

For the reasons stated above, *Amicus Curiae* NDIA urges this Court to grant LISB's Petition for a Writ of Certiorari, accept this case for review, and reverse the Federal Circuit's decision in *Long Island Savings Bank, FSB v. United States*, 503 F.3d 1234 (Fed. Cir. 2007).

Respectfully submitted,

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